FOCUSING CAPITAL
on the LONG TERM

PERSPECTIVES ON THE LONG TERM

Building a Stronger Foundation for Tomorrow

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Focusing Capital on the Long Term is an initiative for advancing practical actions to focus business and markets on the long term. It was founded by the Canada Pension Plan Investment Board and McKinsey & Company.

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A Time for Action

The short-term thinking that pervades our boardrooms, our executive suites, and our financial markets has been spreading for years, slowly impeding the ability of companies to make the kinds of bold investments in the future that sustainable growth and a vibrant economy require. The financial crisis of 2008 and the global recession that followed, however, brought the issue to the fore and galvanized our two organizations to found Focusing Capital on the Long Term (FCLT), an initiative dedicated to uncovering practical solutions to reverse short-term thinking. Our goal is to reorient individuals and institutions across the investment value chain toward a longer-term and more expansive mind-set that takes into account both immediate goals and the longer-term interests of corporations and society.

The FCLT initiative has already helped advance our understanding of the roots of short-termism and how it plays out across the economy. The causes are many, from the "tyranny" of quarterly earnings targets to ill-conceived incentive systems to certain regulations that inhibit the ability to make long-term investments. But our research also shows that business leaders would like to break free of such constraints. We see this both in broad-based surveys and in the conversations we've had with more than 100 CEOs, all of whom tell us that the constant demand to meet 90-day earnings targets has become a straitjacket inhibiting the execution of sustainable, long-term strategies. Board members also feel the pressure. Indeed, a number of public-corporation business leaders we have spoken to are contemplating taking their companies private to escape the yoke of quarterly capitalism.

Now is the time to formulate practical solutions that can help put our economic system on a more stable foundation and allocate resources in ways that provide the greatest value for the broadest range of stakeholders. The essays in this book are part of that effort.

By providing a platform for views from a wide range of economic actors, including CEOs, board members, investors, and regulators, our aim was to foster a lively conversation about what it will take to change the current system. These are the opinions of the individual authors and not McKinsey & Company, the Canada Pension Plan Investment Board, or the FCLT initiative. But as the essays came together, we've been intrigued by how often themes and insights recur.

The context for short-term thinking, including the human traits that reinforce it, is one such theme. Laurence Fink, CEO of BlackRock, describes "our gambling culture," in which the siren song of quick wins—despite what are often much higher long-term costs—has become a societal addiction. Nitin Nohria, dean of Harvard Business School, points to the workings of the human psyche that help make short-term decision making, with its false sheen of certainty, so irresistible.

Others dig deep within our institutions to find specific mechanisms of short-termism that can be reengineered to encourage longer-term thinking. For Charles

Tilley, CEO of the Chartered Institute of Management Accountants, part of the answer is to look beyond the columns of quarterly numbers in assessing the health and prospects of an organization to a richer narrative report that lays out a deep understanding of a company's business model and the factors that might affect it over the long run. Angelien Kemna, chief finance and risk officer of Netherlands-based institutional investor APG, analyzes the ways in which well-meant regulations can have unintended consequences that thwart the ability to take a long-term view of investments.

Many of our writers note that what happens in the boardroom has a tremendous influence on management's ability to execute for the long term. Ronald P. O'Hanley, former president of asset management at Fidelity Investments, outlines specific steps for building a board that supports and enables a long-term strategy.

When it comes to long-term investing, many take the view that anything with a time horizon of five years or more qualifies. Others, however, push the timeline further out. Lei Zhang, founder of Hillhouse Capital Management Group in Beijing, doesn't just invest in companies, he invests in the people who start and run them. The relationships he develops allow him to be deeply involved in strategy at his portfolio companies as they grow and change course over the years. For Zhang, the quarterly earnings report is irrelevant.

We believe the world is approaching a tipping point. The memory of a global financial system on the brink of meltdown is still fresh. Now, a consensus is growing that in a globalized, digitized world, our approach to capitalism must evolve if individual savers are to have the confidence that their investments will grow steadily enough to fund a life that includes a home, an education for their children, and a reasonable retirement. We hope that the work of FCLT, of which these essays are a part, will help point the way to building a stronger, more sustainable capitalism for the 21st century.

Dominic Barton
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CONTEXT

Our Gambling Culture

The craving for immediate gratification has spread well beyond Wall Street.

Laurence Fink is the chairman and CEO of BlackRock, which he has led since its founding in 1988. Previously, he was a managing director of First Boston. Fink is also cochairman of Partnership for New York City, which works with the business community to advance the city's economy and maintain its position as the center of world commerce, finance, and innovation. Fink earned both a BA and an MBA from University of California, Los Angeles.

We tend to speak of short-termism as though it's a problem that only afflicts investors or corporate leaders, but that's not the case. Short-term thinking pervades our most important institutions, from government to households. We've created a gambling culture in which we tune out everything except the most immediate outcomes. If we're going to meet our commitments to our children and grandchildren, and to society as a whole, we need to open up the lens and start taking a more responsible, longer-term view of the challenges we face.

There's a host of reasons short-termism has taken hold in our culture, both in the United States and more broadly. Greed and the media's reliance on daily bombardments of bad news certainly play a part, but more important, we've lost sight of our actual goals. It's in everyone's interest to provide opportunities for education, a reasonable level of healthcare, and a secure retirement for the most people possible, just as we should all be working to conserve our natural resources to assure that clean air, clean water, and renewable fuel sources are available to our children.

Instead, we've become mesmerized by the possibility of short-term, one-off gains. There's a chicken-and-egg problem at work. In many cases, there is a serious misalignment of incentives. Instead of encouraging our institutions and our leaders to grapple effectively with complex, long-term challenges, we're rewarding them to do the opposite. Often, there seems to be a great deal more upside to placing a simple bet for a quick win than for staying the course through difficult times to create sustainable gains that are more widely shared. Whether the wrong goals led to the wrong incentives or the reverse is hard to say.

We see this myopia in Washington all the time. Congress has shown an astounding willingness over the past few years to focus on political theater such as debt-ceiling brinksmanship instead of solving long-term problems, fiscal and otherwise.

Even our tax code seems designed to encourage short-term strategies. Paying significantly lower taxes for capital gains, a major component of tax policy, is predicated on one-year holding periods. Who really believes a one-year commitment is long term? We made things worse when we shifted a few years ago to treating dividends as capital gains instead of ordinary income. That accelerated the tendency for companies to opt to return cash to shareholders in the form of dividend payouts or share buybacks—rather than reinvesting those funds in the business by developing a new technology, say, or building a new factory. The latter are the big, long-term bets that create jobs and keep an economy on top of the innovation curve. By not making them now, we're robbing the future.

This wholesale return of cash to shareholders helps explain why equity markets are outpacing the economy. In the short run, we are rewarding shareholders, which causes the stock to spike. But to the extent that those cash expenditures starve corporate investment, the economy suffers. In particular, people who are riding the current wave will pay for it later when the ability to generate revenue in the long term dries up because of the lack of investment in the future.

It's hard for even the most dedicated CEO to buck this trend. I do believe most CEOs would rather be making investments for the long-term growth of their companies. I don't think they're all motivated just to protect their jobs, but the government is not providing an environment that encourages those very long-term investments.

We should be using the tax code to change this behavior, not reinforce it. For example, another form of short-termism that makes it difficult for companies to focus on long-term strategy is the constant pressure to produce quarterly results. Where does that pressure come from? It comes from investors who are renters, not owners, who are going to trade your stock as soon as they can pocket a quick gain—or sooner if there's no such gain in the offing. But what if we made three years rather than one the holding period necessary to qualify for capital-gains treatment and at the same time brought down the capital-gains tax for each year an investor held, perhaps reducing it to zero at the end of ten years? And on the other end, what if we taxed capital gains at an even higher rate than for ordinary income if the stock was held for less than six months? These measures could quickly help to enlarge the population of engaged investors willing to ride out short-term slumps to better position the company for the long haul. These are the types of behaviors we need to encourage.

> Instead of encouraging our institutions and our leaders to grapple effectively with complex, long-term challenges, we're rewarding them to do the opposite.

The scourge of short-termism wouldn't be so bad if the fallout only hit corporate leaders or policy makers, but the truth is that short-term thinking has serious consequences for everyone. One of the biggest challenges we face is the need to fund longer retirements. In my opinion, this will be a bigger crisis than access to healthcare or a depleted Social Security fund. We're all going to be living longer. We know that. But we haven't focused on what a longer life means or how we're going to support ourselves through it. Most people are severely underestimating the assets necessary to live in dignity during a long retirement.

That retirement problem became much more acute when we migrated from defined-benefit pension plans to defined-contribution plans. I don't believe the average individual is equipped to make those investment decisions properly. Most people invest too conservatively when they're young, with a high percentage in cash and bonds. The reality is that most defined-contribution plans are going to be inadequate for a person's needs during retirement. We're not addressing these fundamental issues. There is a policy need on both the company and government levels. Companies need to be more aggressive about educating their employees on their retirement options, and the government needs to endorse policies that give people incentives to save.

So how do we fight back against short-termism? I believe the most effective antidote lies in more education and more communication—and more leadership.

Another challenge that cries out for a long-term solution is infrastructure, where we are sinfully guilty as a country of simply ignoring a problem that becomes exponentially worse with neglect. We have not for a long while led the world in transit systems, bridges, tunnels, highways, or other major civic investments. Anyone who's taken a bus or a cab from John F. Kennedy International Airport into Manhattan—or marveled at the lack of a direct rail link from the airport—would have a hard time believing he or she was driving through the world's leading economy. Other countries are behind, too, but they're not as behind as we are.

This gets back to a lack of leadership. There's actually a lot of money available for infrastructure investment. But government at all levels in the United States tends to add complexity, making it difficult to plan and initiate large-scale projects. Developers and investors must deal with competing agencies and jurisdictions. It's often difficult to tell who's responsible: whether it's the locality, the state, the federal government, or something else entirely. Most investors will say, "You know what, it really doesn't pay to have a team focus on the United States, because it takes so long. Let me send the team someplace with a more conducive atmosphere, where I can actually get a project off the ground." We are leaving our cities and towns worse off for our children as a result.

So how do we fight back against short-termism? I believe the most effective antidote lies in more education and more communication—and more leadership. We need a call to arms with many more voices speaking up and taking a stand. Just to point to the media, its basic narrative in most cases is so short term. I mean, instead of having television shows focusing on the next trade, could we ever have a television show about critical long-term topics such as preparing for retirement?

The communication imperative is certainly critical for our business. (For more on effective communication, see sidebar, "What Investors Want.") Most of our holdings are long dated. More than 80 percent of BlackRock's equity ownership is in index products. So whether we like the company or have concerns about its long-term prospects, if it's in the index, we have to own it. That's true even if the company is doing something that accelerates the stock price in the short term but has long-term negative implications—maybe making a massive stock repurchase or issuing debt at an unsustainable level or transitioning to a more volatile business model. The stock may rally for a while, but long-term viability is harmed. We have to be against that, but again, we have to own the stock as long as it's in that index.

Therefore, to serve the interests of our clients, we try to ensure that we have robust, ongoing communication with the board of directors. That doesn't mean that we want to tell companies what to do. We think that the board should be working with management to make the important decisions. We do, however, want to make sure there is a high-quality board and management team in place and that we have ready access. We're focusing on the best long-term interests of the company and, more important, we're focusing on the long-term interests of our clients.

That kind of ongoing conversation can serve as a deterrent against getting caught up in the lure of fleeting gains. Deep conversation with engaged participants can serve as a check and balance against a focus that

That kind of ongoing conversation can serve as a deterrent against getting caught up in the lure of fleeting gains.

is too short term. It's a way to keep critical long-term goals front and center, whether it's the need to save and plan for retirement, build and maintain bridges and tunnels, or preserve the environment for the next generation. There are no easy or quick answers to these complex challenges. That's why it's essential that we all stay engaged, join in vigorous debate, and manage those challenges for the long term. ■

What Investors Want

In 2014, Laurence Fink sent a letter to the CEOs of all companies in the S&P 500 stock index, urging them to take a longer-term outlook on strategy and build engagement with investors. BlackRock is doing its part to make sure that communication happens. As the world's largest asset manager, with some $4 trillion under management, it devotes enormous resources to engaging with boards and driving better communication with its approximately 14,000 portfolio companies. Here's some of what it looks for:

A framework for investors. A long-term strategy is critical. Investors need a detailed understanding of the strategy, as well as benchmarks, milestones, and metrics for assessing performance.

A clear articulation of the risks. Investors want to know exactly what the risks are and how corporate leaders intend to manage them.

Proactive rather than reactive communication. Corporate leaders should not wait to be asked the right questions by Wall Street analysts or investors. Rather, they should take control of the conversation and communicate the strategy.

Filings that don't hide behind numbers. Even US Securities and Exchange Commission filings are an opportunity to communicate. BlackRock would like to see more clear prose in these reports rather than just technical, legalistic jargon and columns of numbers.

Learn from your mistakes. They happen to everyone. Investors want to see a mea culpa and, more important, a clear explanation of the fix.

Restoring Trust In an Era of Change

Now is the time to address the world's complex challenges with solutions based on the long-term good. But first we must rebuild faith in leaders and institutions.

Richard Edelman is the president and CEO of Edelman, the world's largest public-relations firm. He has extensive experience in marketing and reputation management and has counseled several countries on economic-development programs, including Egypt, Israel, and Mexico. As the creator of the annual Edelman Trust Barometer, Edelman has become an authority on trust in business, government, media, and nongovernmental organizations. He holds an MBA from Harvard Business School and a BA from Harvard College.

We are in an era of discontinuous change unprecedented in scale and speed. As Klaus Schwab, founder and executive chairman of the World Economic Forum, said, "Whether it's the global economy, the geopolitical landscape, the environment, or technological breakthroughs, we are in the midst of several transitions occurring simultaneously, and what is more, on an epic scale, all reinforcing each other in a web of complex interactions." Such change brings both potential for advancement and societal challenges to be reckoned with: soon we will be able to know exactly what is in every consumer's refrigerator, yet we will not be able to feed the planet. Fracking has made the United States less dependent on energy imports, but it is illegal in much of Europe because of fundamentally different views of environmental risk.

Certainly for business, these complex cross-border challenges present opportunities to innovate, for business is fast and flexible in ways that other institutions cannot match. For government, the era of change brings new expectations of leadership to determine the rules of the game on privacy, food safety, and pensions. All this should point to an unprecedented opportunity to build the institutions and practices that could contribute to a culture that takes a truly long-term approach to addressing difficult and complex challenges.

The timing, however, for business and government alike, is ill fated. In this uncertain and dynamic moment when confidence is needed most, both institutions are faced with a cataclysmic loss of trust. The unraveling for business began with the crash of new-economy companies in 2002, some of which were found to be built on fraudulent accounting. This was followed by the controversial US invasion of Iraq in 2003, causing trust to waver in government. In 2008, as developed nations fell into a severe recession, centerpiece companies in the global economy such as Citibank, General Motors, and Royal Bank of Scotland failed, prompting huge government bailouts. Finally, the botched response by Japan's largest utility to the nuclear catastrophe at Fukushima in early 2011 underscored the inability of these key institutions to work collaboratively and to tell the hard truth to constituents.

THE TRUST GAP

According to the 2014 Edelman Trust Barometer, there is a record gap of 14 points in trust levels between business and government—with business being more trusted in the United States by 20 percentage points and by more than 40 percentage points in countries such as Mexico and South Africa. And yet what persists is a desire for more regulation of business by government in the sectors experiencing the most rapid innovation; in the energy, technology, financial-services, and food industries, respondents voice that desire by a four-to-one margin.

We find ourselves in a new landscape of trust, characterized by four central changes. First, there is an unprecedented dispersion of authority away from traditional sources of leadership and toward a reliance on academic experts or friends and family. The least trusted sources of information are now chief executive officers and government leaders. In fact,

> Trust is no longer earned by quantitative operational metrics—such as company profits—but by the values the company or country exhibits through its actions.

less than 20 percent of people believe that a CEO or prime minister will tell the truth in a complex or difficult situation. The classic pyramid of authority, with elites at the top and a mass audience at the bottom, has been supplemented by passionate consumers contributing to the conversation. We note the rise of nongovernmental organizations (NGOs), the fifth estate in global governance, taking up trust lost by business and government. In fact, in China, NGOs now rank highest among all institutions, trusted by 84 percent of respondents—up from 50 percent five years ago.

The second change is the advent of skepticism. Today, a person has to see something in three to five different places to believe it, and the average informed person has eight daily sources of information. Horizontal peer-to-peer communication based on search engines or social networks now coexists with the formerly dominant model of top-down vertical communication, which allowed for messages to be controlled and audiences sequentially addressed. Online search engines are the first place that people go for general business information. Simultaneously, the primary means of spreading knowledge is via the community, for example, through friends on Facebook. Mainstream media find that the majority of their digital readers actually come to their sites via search or social media.

The third shift is that trust is no longer earned by quantitative operational metrics—such as company profits—but by the values the company or country exhibits through its actions. In the period leading up to the Great Recession of 2008, companies could achieve high trust scores by having outstanding financial results, great products and services, and a well-regarded CEO. Today, financial performance and CEO reputation are simply table stakes. The new drivers of trust—incidentally, also the areas in which both business and government fall short—are placing customers and constituents ahead of profit or political gain, being transparent about how and why decisions are made, paying appropriate levels of tax, and treating employees well.

The final change is growing populist sentiment. Recently, revulsion in China over a reported hit-and-run incident involving a wealthy young man driving an expensive car spread quickly on social media, with a subsequent arrest and conviction. The protest movement Occupy Wall Street effectively demonized the wealthiest 1 percent, while Oxfam reported that the wealthiest 85 people in the world have as much net worth as the 3.5 billion poorest citizens. The economist Thomas Piketty's best-selling book *Capital in the Twenty-First Century* makes the case for substantial taxes on income and wealth on the basis of outsize economic returns on capital. Our most recent trust study indicates that, by an eight-to-one margin, there is a desire for more government taxation of the wealthy; a concurrent sentiment suggests that the wealthy hold too much political power by a nine-to-one margin. The specific outgrowths of this sentiment are the 75 percent marginal income-tax rate in France and stringent bonus curbs on bankers in the United Kingdom.

> CEOs must take on the new job of chief *engagement* officer, going beyond the transactional nature of business and forging relationships that build trust.

A LICENSE TO LEAD

To build trust in this new landscape—at a time when the effects of discontinuous change necessitate confidence in institutions—business must evolve its aspirations. In effect, business must shift from "license to operate" to "license to lead"—moving from a microeconomic, legalistic focus on solving challenges of production, delivery, marketing, pricing, innovation, and finance *alone* to focusing on macroeconomic and societal challenges as well. Premised on Professor Michael Porter's seminal essay on shared value,[1] this envisages business enlarging its role beyond the attainment of quarterly earnings, returning to its roots as a societal problem solver and long-term value creator. In effect, business must embrace a long-term view of its purpose and value.

As our most recent trust data reveals, more than eight in ten adults agree that "companies can pursue their own self-interest while also doing good for society." To fulfill this new role and expectation, business must do more than sell a specific project or product. It must accept the responsibility of explaining how the project or product fits into a broader policy framework and why it benefits the community. It must provide the larger societal context that is lacking and that is sought in a world of change. We see this concept brought to life through a number of recent corporate actions. Gap announced that it would raise salaries beyond minimum wage for its workforce in stores, with the expectation that it would better attract, motivate, and retain the best workers in retail. CVS stated that it would ban tobacco and related products from its stores, maintaining that selling tobacco ran counter to its purpose and that the customer loyalty and brand equity from the decision would compensate for the $2 billion in lost revenues. Unilever's Project Sunlight has moved more than 100 million people to commit to environmentally supportive behavior such as cold-water wash. All

The Occupy movement was a vivid sign of a growing popular distrust of Wall Street.

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these actions carried short-term costs but were undertaken because of the much greater long-term benefits that would accrue.

Under the framework of "license to lead," CEOs must take on the new job of chief *engagement* officer, going beyond the transactional nature of business and forging relationships that build trust. CEOs should begin by participating, reaching out to communities to listen to views that might affect the ultimate product. In so doing, they can also work with NGOs as credible partners who can help to safeguard the public. Next, CEOs must advocate, assuming the bully pulpit to champion the project. This is the opposite of the usual behavior, which limits CEO participation to lobbying elected officials or regulators in the capitals of the world. A key part of this is for CEOs to recruit their own team, their employees, by educating them on the promise of the product or project and then allowing them to speak up. Finally, CEOs must agree up front to evaluate progress in a public manner. This depends on having clearly stated objectives and reporting on progress against them within specified time frames, even when objectives have not yet been met. The new normal of transparency via frequent reporting on results is the guarantor of public confidence.

CEOs must take on this broader responsibility to achieve acceptance by stakeholders of today's faster innovation and problem solving. Peggy Noonan of the *Wall Street Journal* wrote recently, "Great leaders engender gratitude, loyalty, and love. You have to be brave. You have to stand by your beliefs as long as you know you are right; you have to speak and write the truth. Explaining what you believe involves trusting people to hear and consider." To the bully pulpit business must go. ■

[1] Mark R. Kramer and Michael E. Porter, "Creating shared value," *Harvard Business Review*, January–February 2011, Volume 89, Numbers 1–2, pp. 62–77, hbr.org.

Short-Termism And the Threat from Climate Change

By not acting now, we're allowing the future costs of the greenhouse-gas crisis to compound. Eventually, the consequences will be irreversible.

Henry M. Paulson Jr. is a businessman, China expert, conservationist, and author. He is the founder and chairman of the Paulson Institute, which aims to advance sustainable economic growth, a cleaner environment, and cross-border investments in the United States and China. Paulson served as secretary of the treasury under President George W. Bush and before that was chairman and CEO of Goldman Sachs.

It's fitting to gather views on the long term for a business audience, given the pervasive short-term pressures CEOs are under to demonstrate performance. We all know that outstanding companies and real value can only be built over the long term. The challenge for a CEO is to balance the drive for long-term goals with the need to keep the organization strong in the here and now.

That job is made even harder because the business community is not the only sphere in which short-termism thrives. Nowhere is it more rampant than in our political system. One of the things I learned in Washington is that it's very hard to get Congress to do anything controversial or difficult unless there's an immediate crisis.

LEARNING FROM THE FINANCIAL CRISIS

Climate change is where short-term thinking and long-term consequences collide for businesses and governments alike. Meeting the challenge of climate change calls on both to assess the risks and act before the economic and environmental consequences of failure are irreversible. As someone who has spent a good deal of time assessing risk and dealing with crises, I'm struck by the similarities between the climate crisis and the financial crisis of 2008.

Today, we're making the same mistakes when it comes to climate change that we made in the lead-up to the financial crisis. We're building up excesses (debt in 2008; heat-trapping greenhouse-gas emissions now). Our government policies are flawed (providing incentives for borrowing too much to finance homes then; providing incentives for the use of fossil fuels now).

The greenhouse-gas crisis, however, won't suddenly manifest itself with a burst, like that of a financial bubble. Climate change is more subtle and cruel. It's cumulative. And our current actions don't just exacerbate the situation—they compound it. Indeed, our failure to make decisions today to avert climate disaster tomorrow is even more serious than our failure to avert the credit crisis in 2008. The carbon dioxide and other greenhouse gases that we emit into the atmosphere today will remain there for centuries, and government will not be able to avert catastrophe at the last minute.

We're already feeling the impact. For example, the higher sea levels off the coast of New York City—sea levels that led to a storm surge that devastated parts of the city during Hurricane Sandy—are the result of public- and private-sector decisions made decades ago.

So what does this mean for businesses and investors trying to plan for the future? It means that even as we're spending money to adapt to the current state of our climate, we're also making decisions today that risk locking us into long-term consequences that we'll certainly have to adapt to, at far greater cost, far into the future.

In an effort to better understand these risks and to measure their cost to specific sectors of the US economy, I recently joined with former New York City mayor Michael Bloomberg and

Climate change is where short-term thinking and long-term consequences collide for businesses and governments alike.

the investor and philanthropist Tom Steyer to cochair the Risky Business Project. Our goal was to take a standard risk-management approach to climate change. (See sidebar, "Climate Change in our Lifetime.") We asked independent researchers to model the specific consequences of continuing along our current emissions pathway for three major industries—agriculture, energy, and real estate.

The results were sobering. The US economy faces multiple and varied risks from unmitigated climate change. These are disproportionately significant in certain regions, and they are not all decades in the future: for example, projected changes in sea level, combined with changes in hurricane activity, will likely increase the cost of coastal storms along the East Coast and Gulf of Mexico by 11 to 27 percent in 15 years, representing an additional $3 billion to $7 billion in average annual damage. This has serious implications for developers, insurers, bond raters and issuers, and local governments in these areas—not to mention current property owners and businesses located along the coastlines.

In the Midwest region, some states, including my home state of Illinois, will likely experience significant losses in crop yields for our major commodity crops of corn, soy, wheat, and cotton. Absent major adaptation efforts on the part of farmers and agribusiness, some states in the Southeast, lower Great Plains, and Midwest risk up to a 50 to 70 percent loss in average annual yields for the same crops by the end of this century.

And for states across the South, hotter conditions will make outdoor work nearly impossible for large portions of the summer. Texas, for instance, experienced an average of 43 days a year with temperatures above 95 degrees Fahrenheit over the past 30 years. This number will likely reach up to 80 days over the next 5 to 25 years, nearly doubling, and rise to more than 100 days a year by midcentury.

We took a conservative approach in the Risky Business Project report, looking only at the most clearly foreseeable effects of climate change. But the data we didn't consider are even more disturbing. Most scientists believe that the single biggest tipping point on climate change will come with the melting ice sheets in the Arctic and Antarctic.

Fewer than ten years ago, scientists projected that melting Arctic sea ice would result in virtually ice-free Arctic summers by the end of this century. Now, the ice is melting so rapidly that such a result could be a reality in the next decade or two.

> Climate change is not just an issue that poses significant economic risk for businesses; it also poses a huge fiscal risk to the United States.

More troubling, two new studies reveal that one of the biggest thresholds has already been crossed. The West Antarctic ice sheet has begun to melt, a process that scientists say may take centuries but that could eventually raise sea levels by as much as 14 feet. Now that the melting has begun, we can't undo the underlying dynamics, which scientists say are "baked in."

MANAGING CLIMATE RISK IN THE PRIVATE SECTOR

Understanding these potential impacts is one thing. Seriously planning for them is another. As my friend and Risky Business Project cochair Mike Bloomberg likes to say, "If you can't measure it, you can't manage it." Well, now we've measured. It's time to manage.

What does managing climate risk mean for the private sector? In the short term, it includes a significant amount of adaptation. Businesses need to take steps to shore up their supply chains and physical infrastructure to guard against disruption from the extreme heat and weather events that are the hallmark of a changing climate. We're already seeing these adaptive efforts from companies such as Colgate-Palmolive, which reduced its exposure to climate risk by closing, relocating, or strengthening sites that were increasingly exposed to severe weather conditions as part of a larger restructuring program.

Companies are also beginning to make future infrastructure-investment and siting decisions based on the latest climate science. Shell, for instance, employs advisers to conduct assessments of future climate-change conditions for large new projects in regions such as the Arctic (projecting sea-ice conditions for 2030 to 2050), the North Sea (wave conditions for 2010 to 2020), and tropical areas (cyclone severity for 2010 to 2030).

While these businesses may be doing better than many governments in dealing with crisis, there is still much that needs to be done. The business community can't stop at adaptation. We need to reduce the risk of future climate events.

Individual companies can do some of this. For example, utilities can build renewable-energy facilities to meet the power demands that will come with increasing temperatures rather than defaulting to carbon-based energy sources.

Disclosing climate risk and actions in financial reporting would also sharpen the focus for management and investors.

This roller coaster in the surf off a New Jersey beach became an iconic image of Hurricane Sandy—and a sign of the destructive force of climate change, which drives rising sea levels and more powerful storms.

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An even greater service would be for businesses to take a more active role in working with government to put in place the kind of long-term, consistent policy framework we need to ensure a more sustainable economic future.

THINKING LONG TERM IN THE PUBLIC SECTOR

Climate change is not just an issue that poses significant economic risk for businesses; it also poses a huge fiscal risk to the United States. Government has a responsibility to take the long view on this issue—and there is every incentive to do so.

When natural disasters strike, government intervenes, spending billions of taxpayer dollars on disaster relief and recovery and on shoring up infrastructure to guard against future events. Indeed, this is the proper role of government. However, policy makers can no longer afford to ignore the underlying reasons for the increase in the number and severity of natural disasters. To do so jeopardizes our fiscal future, particularly given the severity of climate risk. If we don't change course, wide-scale government interventions will increasingly add to the national deficit, which will hamper growth and competitiveness while siphoning off public dollars that could be spent in other critical areas.

Instead, the federal government should be addressing the fiscal realities of inaction, first by investing in basic research on new technologies, which only the public sector can do at a scale commensurate with the magnitude of the problem. Also, government must put policies in place that let the market direct resources toward smart investments. A price on carbon, for instance, would help unleash a wave of innovation for new technologies, promote efficiencies, and change corporate and consumer behaviors.

Unfortunately, politics sometimes stand in the way of smart decision making. That's why it's incumbent on business leaders, who create jobs and economic opportunities in every district of this country, to stand up and push our policy makers to take action to avert the looming climate bubble.

THE GLOBAL CHALLENGE OF CLIMATE CHANGE

Of course, climate change is not just America's problem. This is an issue of vast proportions, which knows no geographic borders, and stemming it requires a global full-court press. I believe this must begin with bilateral action between China and the United States—the world's largest economies, energy users, and carbon emitters—to demonstrate leadership that will, in turn, prompt global action. The climate deal struck by President Obama and President Xi in 2014 is an important and commendable step in this effort. Frankly, continuing to work closely with China may be our only real hope for solving the climate crisis.

This is one of the areas where our countries' private sectors, governments, and nonprofit institutions have a strong shared interest to work in complementary ways to push for action and to develop and deploy new technologies on a cost-effective basis in the developing world. The challenge will be the speed with which we can come together in meaningful ways around a problem of this scale. But the good news is that no nation on earth innovates better than the United States, and China can roll out and test new clean

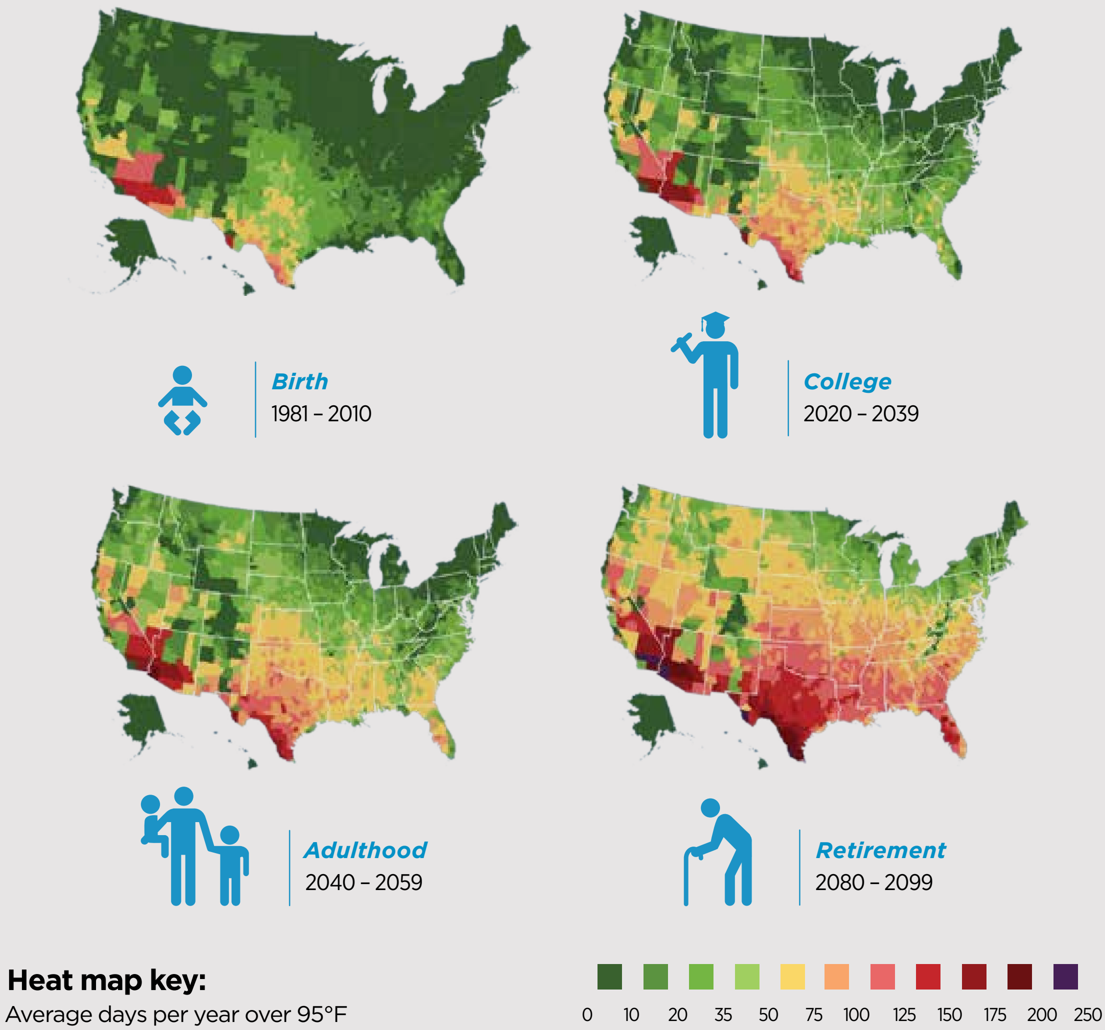
Climate Change in our Lifetime

To assess the risks of rising temperatures, the Risky Business Project relied on analysis of both high- and low-probability outcomes and the economic consequences on a regional basis, as well as for specific sectors of the economy. Those costs included the loss of property along coastlines due to rising sea levels and increases in hurricane activity, changes in commodity-crop yields attributable to temperature and precipitation changes, and increased electricity demand corresponding to hotter days across much of the continental United States. The research found additional costs associated with heat-related mortality and losses in labor productivity.

To illustrate how profound and rapid these changes might be, the Risky Business Project mapped the increase in the average number of days per year with temperatures over 95 degrees Fahrenheit across the United States over the course of a lifetime for a child born in 1981, assuming our current trajectory. As the heat maps show, such a child could be born in one climate and die in another that's quite different, without ever moving from the region (exhibit).

The Risky Business Project, chaired by Michael Bloomberg, Henry Paulson, and Tom Steyer, is a partnership dedicated to quantifying and publicizing the economic risks of climate change. The results of that research can be found at *riskybusiness.org*.

Average Days Over 95°F: Projections Mapped Over a Lifetime



On our current path, the US will likely see significantly more days above 95°F each year. Some regions of the country will be hit far harder by extreme heat than others, and some will experience rising temperatures in terms of warmer winters rather than unbearable summers. But by the end of this century, the average American will likely see 45 to 96 days per year over 95°F.

DATA SOURCE: RHODIUM GROUP; GRAPHIC ORIGINALLY APPEARED IN *RISKY BUSINESS: THE ECONOMIC RISKS OF CLIMATE CHANGE IN THE UNITED STATES*, THE RISKY BUSINESS PROJECT, JUNE 2014, RISKYBUSINESS.ORG.

energy technologies on a speed and scale like no other.

Here in the United States it's frightening, but not surprising, that our business leaders and lawmakers far too often either dismiss the topic on political grounds or relegate climate change to the back burner to address issues that seem more immediate.

It's time for the United States to get its house in order through policies to curb and price carbon emissions.

For its part, China's air quality has reached a crisis point, and the government has no choice but to act. Spend a day in Beijing, which suffered more than 60 days last year from air pollution that reached hazardous levels and where annual *average* particulate levels are four times the World Health Organization maximum. On especially bad days—those that rate as "beyond index," or off the scale—pollution can reach 20 times the WHO maximum. No wonder China's leaders feel pressure to act.

Recognizing the urgency of the problem, Premier Li Keqiang has declared a war on pollution and launched a new plan for economic reform to set China on a more sustainable environmental path. As a result, we're seeing a noticeable policy shift among the country's leaders.

For instance, the government has introduced new performance indicators for officials based not only on economic performance and social stability but also on environmental management and the quality of growth. China is also taking steps toward pricing greenhouse-gas emissions. Seven regional pilot carbon markets have been up and running in major cities since 2013, with the goal of developing a model for the country—and a nationwide system could be announced within a year.

These are commendable actions, but China has been losing ground from the impact of breakneck growth that has overwhelmed the economy at a significant environmental cost. China is the fastest-growing greenhouse-gas emitter, accounting for some 30 percent of all global emissions. So it's no wonder the country's leaders have placed high priority on cleaning up its polluted air. Chinese citizens demand it—as will the rest of the world.

THE LONG TERM IS NOW

It's time for the United States to get its house in order through policies to curb and price carbon emissions. We must lead, first, because the stakes are high for our environment and for our economy. Moreover, when our own house is in order, we are in a better position to press China and other developing countries to take difficult but necessary steps to curb this crisis.

Given the stakes for our environment and for our economy, it's also time for the business community to urge government to enact smart and sustainable policy solutions. After all, politicians listen to the business leaders in their states and districts—in addition to the general public that elects them.

We can't afford to ignore this crisis. It's as if we're watching as we fly slow motion toward a giant mountain. We can see the crash coming, but we're sitting on our hands instead of altering course.

It's time to turn the wheel. ■

Lynn Forester de Rothschild

Capitalism For the Many

It's time to relevel the playing field and extend the benefits of our economic system.

Lynn Forester de Rothschild is the CEO of E.L. Rothschild and cofounder of the Coalition for Inclusive Capitalism. She has served as cochair of FieldFresh, an initiative to develop the agricultural sector in India, and as president and CEO of FirstMark Holdings. Rothschild is a director of both the Estée Lauder Companies and the Economist Newspaper, where she serves on the audit committee. She graduated from Pomona College and earned a law degree from Columbia University.

These are not the best of times for capitalism. We have free and open markets to thank for the rapid growth in incomes and living standards over the last three centuries. Yet in recent decades, capitalism has lost its luster and is no longer viewed as a sure path for the fair distribution of prosperity. Wages for many workers have stagnated, while the fortunes of the very rich have multiplied. Rising inequality is amplifying social divisions. Unfettered capitalism deserves considerable blame for its role in crises of the past as well as those that are still in the making; for damaging shocks to the global financial system; for damage to the natural environment; and for low levels of trust and optimism in our societies.

It should come as no surprise, then, that the public is losing faith in capitalists and capitalism. According to the 2014 Edelman Trust Barometer, only 20 percent believe that a CEO will tell the truth in a complex or difficult situation and only 21 percent believe business leaders make ethical and moral decisions. According to recent polling, less than half of respondents in developed economies like Japan and Spain trust free markets. Even in America, where red-blooded capitalism is woven into the very fabric of society, just 54 percent have a positive view of capitalism, according to a 2013 poll.[1] While it is not the business of business to solve society's problems, it is dangerous when business is perceived as being one of society's problems. The continued erosion of support for capitalism could lead to a backlash that, in turn, could undermine the ability of market economies to deliver economic growth and rising living standards.

Business leaders and investors, alongside government, have an obligation, as well as a strong self-interest, to reverse these trends. A capitalism that is equitable, sustainable, and inclusive is one that will persist and enrich well into the future, and will therefore maintain the confidence of the public. Restoring that sort of capitalism is a primary goal of the Coalition for Inclusive Capitalism. The coalition is part of a broad movement to reform a misfiring capitalist system; it is closely aligned with many other global efforts, among them "conscious capitalism," "sustainable capitalism," "fair capitalism," and "equitable capitalism." The aim, however one refers to it, is to save unbridled capitalism from itself.

That may seem a dubious premise; "inclusive capitalism" will strike many of capitalism's critics as oxymoronic. Yet to Adam Smith it would have been a redundancy. Smith, the father of modern economics, saw the "wealth of nations" as closely linked to the wealth of individuals. A market system could provide a comfortable life for most of society, he believed. But a sensible capitalist system would balance personal opportunity with personal responsibility. Rather than a heartless, laissez-faire economics, Smith sought a market constrained by common values and a commitment to shared prosperity.

> A capitalism that is equitable, sustainable, and inclusive is one that will persist and enrich well into the future.

Indeed, until very recently it was taken for granted that business was about more than the narrow-minded pursuit of profit. For most of the 20th century, the public company was understood to be "a legal entity created by the state for public benefit and run by professional managers seeking to serve not only shareholders but also 'stakeholders' and the public interest . . ."[2] In a speech given at the 2014 Conference on Inclusive Capitalism in London, former US president Bill Clinton elaborated on this point. "Forty years ago," he noted, "corporate law and practice were taught pretty much the way they had been since the 1930s. That is, corporations, in the West, at least, were creatures of the state. They were given certain legal protections, like limited liability, in return for which they were supposed to respond to the needs of four constituencies: their customers, their shareholders, their employees, and the communities of which they were a part."[3]

Martin Wolf, chief economics commentator for the *Financial Times*, offered similar thoughts. The company, he argued, " is an institutional mechanism for adding economic value. This is the social function of any and all companies, subject to an important proviso: the company should not add value by inflicting negative externalities, such as environmental degradation. Society has given the corporate form important privileges. In return, society has a right to expect obedience to the law and a measure of decency: even if it is not illegal, dumping toxic waste or rigging one's affairs so as to pay minimal taxes to the jurisdictions that provide the environment within which the company can generate its profits is indecent. It is freeloading."[4]

In the hands of my generation, this bargain struck between business and society has broken down. In its place has grown the dogma of shareholder primacy. Milton Friedman, the Nobel Prize–winning economist and intellectual leader of the deregulatory evangelists of the 1970s, may have captured—and propagated—the sentiment best. The "one and only social responsibility of business" is, he famously reckoned, "to use its resources and engage in activities designed to increase its profits."[5]

In the decades since, this view—that firms do best when they focus exclusively on building the bottom line—has dominated corporate boardrooms, with predictable results. Since the 1980s, middle-class wage earners have enjoyed ever less benefit from overall economic growth. The *Economist* recently showed that during Ronald Reagan's first six years in office, GDP grew 22 percent, while median income grew 6 percent. Under Bill Clinton, there was a correlation between overall economic growth and income increases for the middle class: GDP was up by 24 percent and median income grew by 11 percent. For George W. Bush, by contrast, GDP growth was 16 percent while median income declined by 2 percent. And in Barack Obama's first six years, GDP has risen 8 percent but median income has fallen a further 4 percent. Although other factors have no doubt contributed to this performance, a changing corporate culture has surely encouraged the soaring inequality we now observe.

An intense focus on short-term profit has led not only to unequal growth in incomes but also to reduced emphasis on training, research and development, and environmental sustainability. According to research by McKinsey, 55 percent of chief financial officers will reject an investment with an estimated positive return if it means missing the next quarter's earnings targets. And while 44 percent of C-suite executives and board members use a time horizon of fewer than three years in setting strategy, 73 percent say that they should use a time horizon of more than three years. Ever-shorter equity-holding periods add to the pressure for short-term results. The New York Stock Exchange reckons the average holding period for equities fell from about eight years in 1960 to just six months in 2010. Many shareholders want little more than a quick bump in share prices, and firms are listening. The interests of other stakeholders have been pushed almost completely off the agenda.

The bargain struck between business and society has broken down. In its place has grown the dogma of shareholder primacy.

The Coalition for Inclusive Capitalism is determined to work to reverse these trends. The best way to begin is to identify tangible actions firms, investors, and governments can take to change their behavior and strengthen business while also contributing to renewed public trust in the markets.

Although there will be challenges and some difficult trade-offs in this effort, there are several areas where the reforms will be win-win for all the stakeholders in capitalism. There are strong and practical, if often overlooked, benefits to shareholders from investing in companies that operate sustainably and for the long term. Short-termism will often come back to haunt a company; inadequate training, for example, may leave a firm short of skilled workers, while a single environmental disaster can cost a company billions. What's more, doing good can mean doing *well*. In a recent review of the 190 highest-quality academic studies, industry reports, newspaper articles, and books on the impact of integrating sustainability criteria (broadly defined as measurements of environmental, social, and governance impact) into company investment decisions, 90 percent show that the cost of capital is lower for companies with sound sustainability standards, 88 percent demonstrate that solid sustainability practices result in better operational performance for firms, and 80 percent conclude that strong sustainability practices yield improved stock performance.[6]

To see how firms can protect their own viability while doing right by society, consider the economy's need for appropriately skilled workers. Writing in *Bloomberg Businessweek* in 2010, Andy Grove, former CEO of Intel, lamented the loss of American manufacturing jobs to foreign economies. The job loss itself was a concern: "What kind of a society are we going to have if it consists of highly paid people doing high-value-added work—and masses of unemployed?" Yet just as worrying to Grove was the disappearance of accumulated knowledge within manufacturing hubs. "Not only did we lose an untold number of jobs," he wrote, "we broke the chain of experience that is so important in technological evolution . . . abandoning today's 'commodity' manufacturing can lock you out of tomorrow's emerging industry."[7]

The unfortunate loss of this knowledge resource can be fixed. Educational, vocational, operational, and apprenticeship programs could refresh the supply of skilled workers corporations need and mitigate unemployment and inequality. The German economy has retained a globally competitive high-tech manufacturing industry thanks in large part to its apprenticeship system. Tellingly, the European countries with robust apprenticeship programs are among the Organisation for Economic Co-operation and Development countries with the lowest rates of youth unemployment.[8]

Educational, vocational, operational, and apprenticeship programs could refresh the supply of skilled workers corporations need and mitigate unemployment and inequality.

This is not an issue business should fob off on government. Encouragingly, a few pioneering companies are taking the initiative, designing and implementing effective apprenticeship programs of their own. The task of finding qualified workers for advanced manufacturing plants is often hindered by the extremely low number of applicants who can pass a test requiring sixth-grade reading and math skills. In an effort to address this problem, the American subsidiary of Siemens moved to import a German-style apprenticeship program. In its Charlotte, North Carolina, plant, dozens of workers have gone through a targeted course at a local community college. Participants go to school part time while working, and emerge with a two-year degree, applicable skills, and a guaranteed job with Siemens—all without incurring any debt.

In response to Siemens's apprenticeship program (as well as similar ones offered by Alcoa and Dow Chemical), the US Department of Labor is launching the $100 million American Apprenticeships Grant competition, which was designed to encourage experimentation with new models of apprenticeship and training.[9] Alcoa, Dow Chemical, and Siemens, meanwhile, have built on their own successful experiences, developing a "how-to" guide for other employers looking to use apprenticeship as a training strategy.

As the White House noted in its announcement of the grant competition, this is an example of industry leading the way.[10] I hope other companies will follow. If business and government can cooperate to expand these sorts of initiatives, firms will begin to benefit from economies of scale, with reduced costs encouraging the entry of yet more firms that can adopt the best practices identified by early movers. The expansion of these initiatives can also alter vocational training's perceived lower status and legitimize it as a respected alternative track for students who are not interested in pursuing a four-year degree. The end point can and should be a better-trained workforce, reduced unemployment, and a more competitive industrial sector. These efforts to incorporate apprenticeship into the American economy provide just a glimpse of what could be accomplished with a change of focus across corporate America. This effort will not solve all of the issues in a capitalist system that has become too beneficial to too few, but it is an example of how companies, investors, and communities can all benefit through determined, coordinated action.

If capitalism is to have a bright future, it must once again become truly inclusive.

Capitalism has brought the world levels of wealth, prosperity, opportunity, and innovation that no other economic system has come close to matching. Those of us in positions of responsibility within the capitalist system, who have reaped so much from our companies and our markets, are obliged to help put that system on a sounder footing so that it can once again generate long-term and widespread prosperity. If capitalism is to have a bright future, it must once again become truly inclusive. ■

[1] "All it needs is love," *Economist*, November 15, 2014, economist.com.
[2] Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, first edition, San Francisco, CA: Berrett-Koehler Publishers, 2012.
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[8] Hilary Steedman, "Apprenticeship: Remaking an old idea for a new era," mckinseyonsociety.com, 2012.
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[10] "President Obama announces new actions to further strengthen US manufacturing."

The Human Advantage

Computers can do a lot. But only people can think deeply and take the long view.

Nicholas Carr writes on technology, business, and culture. His books include *The Glass Cage: Automation and Us*; *The Shallows: What the Internet Is Doing to Our Brains*; *The Big Switch: Rewiring the World from Edison to Google*; and *Does IT Matter? Information Technology and the Corrosion of Competitive Advantage*. He is a contributor to many periodicals, including the *Atlantic*, *Financial Times*, *New York Times*, *Wall Street Journal*, and *Wired*. Carr was formerly executive editor of the *Harvard Business Review*.

The news raised more than a few eyebrows when it broke in the spring of 2014. Toyota Motor, long renowned as a pioneer in manufacturing technology, had begun replacing some of its robots with human beings. The initiative began at the company's oldest factory, the Honsha Plant in Japan, where responsibility for making crankshafts was transferred from robotic machinery back to people. Eschewing automation, the new workers were producing the critical engine parts the old-fashioned way, by using traditional hand tools to shape hot steel. The program has since spread to more factories and more production processes.

The renewed stress on manual labor is part of a back-to-basics movement at Toyota, an initiative spearheaded by its president, Akio Toyoda. A grandson of the company's legendary founder, Kiichiro Toyoda, Akio has committed himself to nurturing craftsmanship in his organization, with the hope of reinvigorating the automaker's heritage of outstanding quality and productivity. His motivation lies not in any nostalgia for the past but in a hardheaded assessment of the present and future. Having had to recall millions of vehicles in recent years, Toyota has learned a painful lesson about the drawbacks of relying too heavily on computer-controlled machinery. It has come to realize that robots, however fast and precise they may be, can't match the talents or replicate the insights of human experts.

Machines excel at performing the same function repeatedly, but they can't think critically or creatively about what they're doing. It takes skilled and experienced artisans to discern subtle problems in a manufacturing process or to imagine new and better ways of getting a job done. "We cannot simply depend on the machines that only repeat the same task over and over again," Mitsuru Kawai, the veteran Toyota executive who is overseeing the craftsmanship push, told Bloomberg News. “To be the master of the machine, you have to have the knowledge and the skills to teach the machine.” Nurturing human expertise takes time and money, of course. But Toyota has decided that sacrificing some efficiency and income in the short run is the best way to secure its long-term success.

THE HIGH COST OF COMPUTERIZATION

Toyota’s decision to back away, at least a step or two, from computers goes against the grain of contemporary management practice. Indeed, it goes against the grain of social trends in general. For decades now, society has been in thrall to labor-saving information technology. As software has become more adept, computers more convenient, and digital networks quicker and more encompassing, we have, as organizations and individuals, ceded ever more responsibility for our work and our lives to apps and algorithms. It’s not hard to understand why. The benefits of computerization are usually quick to materialize, easy to recognize, and fairly simple to measure. As individuals, we gain immediate access to information that used to be hard to come by, we get things done with greater ease, and we’re able to communicate with friends and colleagues much more quickly than before. Businesses, for their part, gain a clearer view into the workings of supply chains and the behavior of markets, and they’re often able to trim labor costs and boost productivity by automating industrial and managerial processes. The computer has become our all-purpose quick fix. It allows us to solve many small, immediate problems efficiently.

The costs of computerization are harder to discern. They emerge slowly and resist easy quantification. They manifest themselves in a slow erosion of human talent, insight, and creativity and a subtle deterioration in people’s ability to concentrate on hard problems, develop complex talents, and take the long view. And those costs could turn out to be steep. A decreasing ability to grapple with complex problems requiring a long-term strategy could exact a very high toll in the future—far higher than the cost of addressing them now.

> Robots, however fast and precise they may be, can’t match the talents or replicate the insights of human experts.

Because the costs of our reliance on computerization are fuzzy and elusive, while the benefits are so clear cut, we have tended to underestimate the dangers. As a result, we haven’t been good at negotiating the tradeoffs inherent in handing off to software applications and software-controlled machinery the tasks that we used to perform ourselves. Our bias has been to accept every new offer that our ingenious programmers present to us, grabbing the immediate gains with little regard to the longer-term losses.

This tendency is not limited to production processes. For those of us whose jobs aren’t threatened by industrial robots, it’s most apparent in our ever-growing dependency on the Internet as a medium for communication. In a speech delivered back in 1969, when the Net was in its infancy, the social scientist and future Nobel laureate Herbert Simon posited that a glut of information would produce a dearth of attention. Since then, psychologists and neuroscientists have learned a great deal about how our brains respond to distractions, interruptions, and incessant multitasking. What they’ve discovered proves how right Simon was—and underscores why we should be worried about the new digital environment we’ve created for ourselves. When it comes to thinking, we’re trading depth for breadth. We’re so focused on the immediate that we're losing the ability to think more deeply about the long-term implications of complex problems.

One of the most compelling studies of the effects of digital media on our minds was conducted at Stanford University and published in the *Proceedings of the National Academy of Sciences* in 2009. The researchers recruited a group of college students, half of whom spent a lot of time gathering information in different forms online ("heavy media multitaskers") and half of whom spent much less time dividing their attention between different streams of information ("light media multitaskers"). They gave the subjects a series of standard tests of cognitive function. The heavy multitaskers did worse on all of them. They had a harder time maintaining their concentration, resisting distractions, and in general controlling their thoughts. They were scatterbrained. In one of the most revealing and disturbing of the tests, the heavy multitaskers exhibited significantly less ability to distinguish important information from trivia. Their attention simply gravitated to the latest stimulus. The new crowded out the vital. They were, as one of the researchers put it, "suckers for irrelevancy."

> An inability to concentrate on one problem or idea over an extended period impedes the most profound forms of creativity, the ones that lead to counterintuitive insights and momentous breakthroughs.

THE ALLURE OF THE TRIVIAL

The findings shouldn't come as a surprise. Most of us have firsthand experience of the way that smartphones, tablets, and other Net-connected computers seize our attention only to scatter it. And decades of more general research into the toll taken by distraction and multitasking confirm that people become less thoughtful when they're bombarded by messages and other bits of data. Russell Poldrack, who runs a laboratory for cognitive research at Stanford, is a leading expert on the mental impact of interruptions. His research, he says, indicates that people have a significantly harder time grasping facts and concepts when they're juggling distractions. They learn less and remember less, and their thinking becomes shallower. Other studies indicate that an inability to concentrate on one problem or idea over an extended period impedes the most profound forms of creativity, the ones that lead to counterintuitive insights and momentous breakthroughs.

Contrary to common assumptions, the problem doesn't go away as people gain experience in using the web and related online tools. David Meyer, a University of Michigan neuroscientist who is a top authority on multitasking, warns that it's a mistake to believe that people can learn to multitask successfully. No matter how much you practice shifting your focus from one thing to another, he says, you'll never perform as well as you would have had "you just focused on one thing at a time." As we adapt ourselves to the stimulations and interruptions of our digital environment, we're simply training ourselves "to be skillful at a superficial level."

Patricia Greenfield, a developmental psychologist at the University of California, Los Angeles, has spent much of her career examining the effects of technology on thinking and learning. Her work underscores how, as she puts it, "every medium develops some cognitive skills at the expense of others." Our use of computers has given us "new strengths in visual-spatial intelligence." We're better able to keep track of lots of visual stimuli simultaneously, for instance. But what we lose is our ability to engage in the kind of "deep processing" that underpins "mindful knowledge acquisition, inductive analysis, critical thinking, imagination, and reflection." No one interested in the future of human intellect and skill will find much to celebrate in that trade-off.

Why would we allow ourselves to become so reliant on a technology that ends up hampering our thinking and foreclosing our opportunities to excel? One reason appears to be biological. Experiments suggest that we have a deep, primitive inclination toward distraction. We want to know everything going on around us, a trait that probably helped keep us alive when we lived in the wilds. The very act of seeking out new information has been found to trigger the release of the pleasure-producing chemical dopamine in our brains. We're rewarded, in other words, for hunting and gathering data, even if the data are trivial, and so we become compulsive in checking the networked gadgets we carry around with us all day.

But it's not just biology. It's also society. Businesses and other organizations have been complicit in encouraging shallow and distracted thinking. Tacitly or explicitly, executives and managers send signals that they expect employees to be constantly connected, constantly monitoring streams of messages and other information. As a result, people come to fear that disconnecting, even briefly, may damage their careers, not to mention their social lives. Organizations gain the benefits of rapid communication and swift exchanges of data. But what they sacrifice are the deepest forms of analytical and critical thinking—the kinds of thinking that require a calm, attentive mind. The most important work can't be done, or at least can't be done well, in a state of distractedness, and yet that's the state that companies today have come to promote.

Is our ever-increasing reliance on technology leading to shorter attention spans and diminished creativity?

HUMANS IN THE AUTOMATION AGE

Microchips are not going to slow down. Software is not going to stagnate. We're at the dawn of a new era in automation. Thanks to advances in robotics, machine learning, and predictive analytics, computers are becoming adept at jobs requiring sophisticated psychomotor and cognitive skills—tasks that until recently we assumed would remain the exclusive preserve of human beings. Computers are flying planes and driving cars. They're making medical diagnoses, pricing and trading complex financial instruments, plotting legal strategies, and running marketing campaigns. All around us, computers are making judgments and decisions on our behalf.

There has been much discussion about the effects of rampant automation on the economy and on the labor market in particular. There has been much less attention paid to its effects on human talent and motivation. But what decades of human-factors research tells us is that when computers and other machines take challenging tasks away from us, we turn into observers rather than actors. Distanced from our work, we lose our focus and become even more susceptible to distraction. And that ends up dulling our existing skills and hampering our ability to learn new ones. If you've ever gotten lost while following

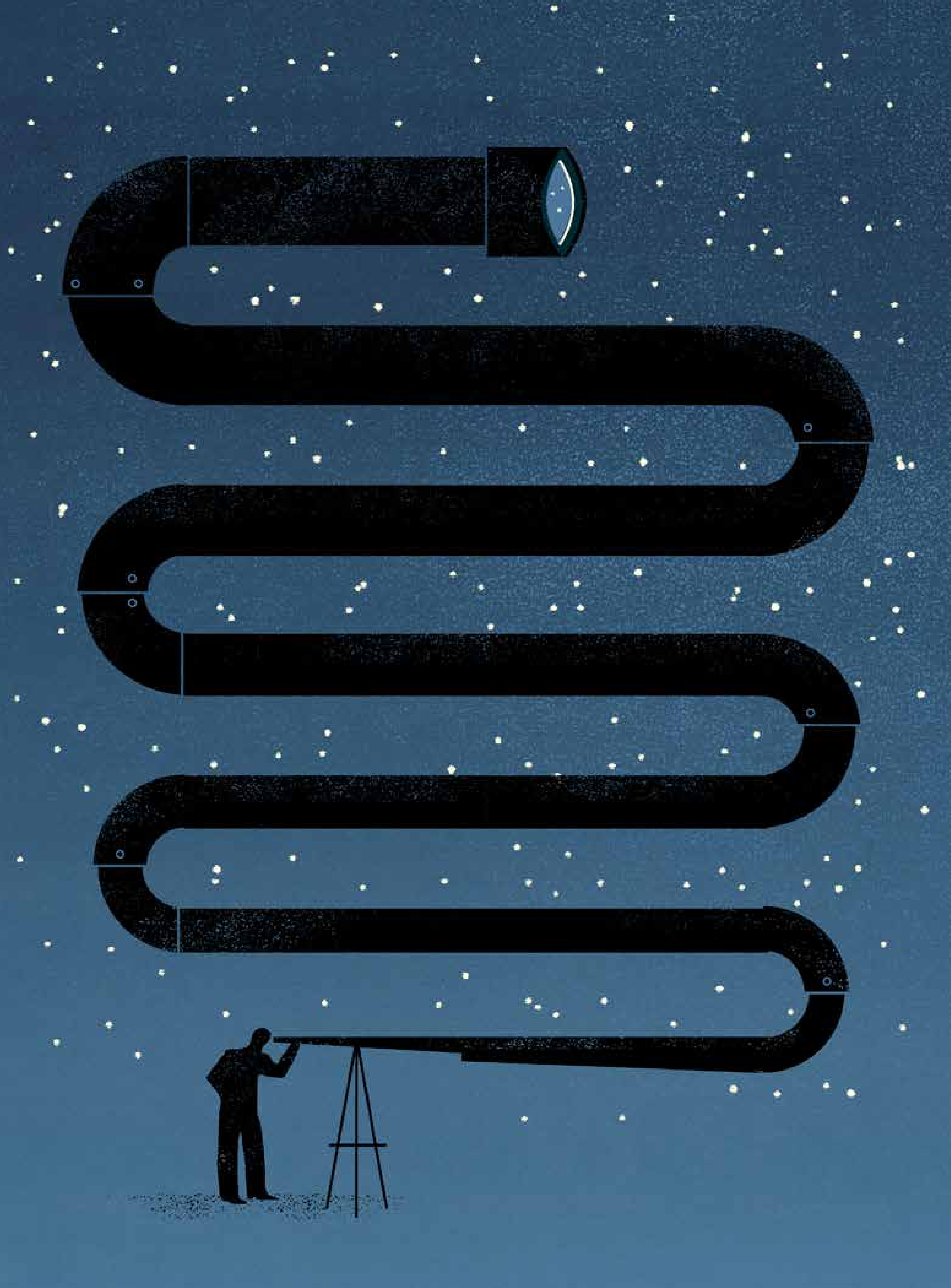
Software can do only what it's told. Human beings, blessed with imagination and foresight, can do the unexpected.

the step-by-step directions of a GPS device, you've had a small lesson in the way that computer automation erodes our awareness of our surroundings and dulls our perceptions and talents.

If computers were able to do everything that people can do, this might not be such a problem. But, as Toyota has discovered, the speed and precision of computers mask their fundamental mindlessness. Software can do only what it's told. Human beings, blessed with imagination and foresight, can do the unexpected. We can think and act creatively, and we can conceive of a future that is different from and better than the present. But we can only fulfill our potential if we're engaged in the kind of difficult and subtle work that builds talents and generates insights. Unfortunately, that's exactly the kind of work that software programmers have been taking away from us in order to deliver short-term efficiency gains and indulge our sometimes self-defeating yearning for convenience.

Donald Norman, a cognitive scientist who has written extensively about the interactions between people and computers, believes that we have taken a wrongheaded approach to designing technology, one that puts the interests of machines ahead of our own. "Society," he says, "has unwittingly fallen into a machine-centered orientation to life, one that emphasizes the needs of technology over those of people, thereby forcing people into a supporting role, one for which we are most unsuited." The dominant design ethic, which now underpins many business strategies and investments, "emphasizes tasks and activities that we should not be performing and ignores our primary skills and attributes—activities that are done poorly, if at all, by machines."

The problem lies not in our computers but in ourselves. Technology may determine how we work, but we determine how technology works. If we are to navigate the age of automation successfully, we need to change the way we design our software and our systems. We need to look to computers not as our replacements but as our assistants, as tools that help us develop and deploy our unique talents—and that free us to apply those talents to the most important challenges, instead of the most ephemeral. We need, as well, to create the organizational and social conditions that allow people to devote the time and mental energy required to think through those challenges without incessant interruptions. If we don't change our approach to technology, we'll end up creating a world better fit for robots than for people. ■



Long-Term Visions Cut Short

Most business leaders want to focus on the long-term, but first they must confront the psychological forces that can foil that aspiration.

Nitin Nohria is the dean of Harvard Business School, where he has been a faculty member since 1988. His academic interests include the theory and practice of leadership and the study of human motivation. Nohria has cowritten or coedited 16 books, including *Handbook of Leadership Theory and Practice* (coedited with Rakesh Khurana). He received a BTech. from the Indian Institute of Technology and a PhD in management from the Massachusetts Institute of Technology's Sloan School of Management.

A decade ago, I joined my Harvard Business School colleagues Bill George, Jay Lorsch, and Michael Porter, to teach in a workshop for new CEOs. Twice each year we welcome about ten new chief executive officers for two days of discussion and reflection. We begin each workshop with the same assignment, asking each CEO to prepare and deliver the speech they hope to give as they are stepping down from the job in the future.

It's an enlightening exercise. The average age of the group is 50, and in almost every speech, they're looking back on a tenure that's lasted about 10 years. In most cases, by the time of the imagined speech, the company's revenue has doubled. So has its market capitalization. The company has become far more global. Its products and services are stronger and customers happier. The company culture is more engaging. And the CEO has just chosen a fabulous successor who was groomed internally.

After they enumerate these accomplishments, the new CEOs typically then reflect on the current problems they face. And they begin to talk about the immediate steps they are taking to address them.

What this exercise reveals is that every CEO has aspirational long-term goals. They all want to make their companies better and stronger in the long term. Yet when it comes to priorities and plans of action, few have headlights that can shine further than two or three years. So while every CEO talks about managing for the long term, the reality is that the crush of immediate concerns and the uncertainty of the future lead them to focus on the short term.

This tension between long-term intention and short-term action is one of the great challenges of modern management. These CEOs are smart and accomplished and have great integrity. They are genuinely committed to the long-term health of their company. But their actions are more often focused on the short-to-medium term.

To explain the discrepancy, many observers point to external forces, such as pressure from Wall Street analysts, institutional shareholders, or activist investors. It's become almost customary for CEOs to accuse capital markets of creating undue pressure; it's the scourge of meeting quarterly earnings expectations, they argue, that prevents them from creating long-term economic and shareholder value. Or it's the structure of incentives for both CEOs and financial-market participants that make short-term results more alluring than long-term gains.

I believe there is an equally important—and less explored—set of internal forces that contribute to this myopia. Three forces that I consider most important are the cognitive asymmetry between the uncertainty of long-term actions and the certainty of short-term actions; the need to maintain ongoing credibility to continue to enjoy the license to lead; and the desire to leave a legacy with the knowledge that it is difficult to do so.

Let's examine each of these three forces in turn.

LEADERS NEED CERTAINTY (Which Can Be Easier To Find In The Short-Term)

By definition, long-term actions are inherently more uncertain than short-term actions. Investments that have a long gestation period are intrinsically risky. It is hard to know when, whether, and to what extent a major investment in a new drug-discovery project, a renewable source of energy, or a new cadre of young high-potential leaders will pay off. It is equally hard to predict exactly when an industry structure will be upturned or when a new technology will truly be disruptive. In my own field, many argue, for example, that the structure of higher education is bound to change and that online educational technologies will be a hugely disruptive force. But the same arguments were made when radio and television emerged. These, too, were seen as fundamentally disruptive for education, but the threat proved to be much more benign. Who is to say that the current technological threat will not turn out to be equally overhyped? When the prevailing tailwinds are still carrying you forward, it is hard to know when you might confront a stall or strong headwinds. It is easier to predict the future when it has already occurred.

In contrast to the uncertainties of the long term, the certainty of the short term feels comforting. Cuts in research and development that have shown so little yield for so long, or in leadership-development programs that don't have a clear return on investment, or in sustainability programs that don't translate into immediate customer sales are tempting because they can immediately improve profitability and may even be applauded as a willingness to make tough calls. Even an expensive acquisition may seem a surer way to boost growth than an uncertain long-term program of organic growth into adjacent markets. To return to the example of business schools (since it is what I know best), rather than make a significant investment in anticipation of an industry shift, such as an unproven new educational technology, it may appear more prudent to invest in the things that will more surely improve student yield in the short term, such as increasing financial aid or better student housing.

> Leaders can find the certainty of short-term actions and their immediate payoffs more alluring than the uncertainty of long-term actions and their harder-to-quantify payoffs.

Leaders can find the certainty of short-term actions and their immediate payoffs more alluring than the uncertainty of long-term actions and their harder-to-quantify payoffs because in the end they, like the rest of us, are simply human. Research in psychology has repeatedly shown that the majority of human beings will prefer the certainty of a smaller immediate reward over a larger future reward. Most people, for example, will choose a $100 reward that they can take home today over a $200 reward they can get a year from now, even when they understand that it would take a ridiculously high discount rate to make the $200 choice inferior.

This pattern of so-called hyperbolic discounting is something everyone is susceptible to. Evolutionary psychologists argue that this short-term tendency was favored by natural selection when resources were scarce, and people who could find and eat food in the short term were more likely to survive than those willing to wait for the long term. It may also explain why, as a wide variety of food has become readily available and easier to prepare, human beings have tended to become more obese. We have to fight our natural tendency to consume food that is tempting in the immediate term. Indeed, evolution makes highly caloric food seem even more tasty and tempting than healthier, less caloric foods. For business, the analogy to food is not so remote. As the number of short-term options for increasing performance has increased (be it through more sophisticated tools for financial engineering or business-process reengineering), it has become more tempting for business leaders to embrace these short-term actions.

A psychological mechanism leaders must confront is that their self-confidence depends on the extent to which they feel supported by the constituencies that must defer to their authority.

LEADERS NEED FOLLOWERS (Who May Have Shorter Time Horizons)

A second important psychological mechanism leaders must confront is that their self-confidence in their leadership depends on the extent to which they feel supported by the constituencies that must defer to their authority—and that confer upon them the legitimacy to lead. Put simply, if the employees in your organization lose faith in you, it is hard to exercise leadership. It takes divine force to hold people together through many years of suffering in the desert before they reach the promised land. And, as even Moses discovered, that can be a period of profound doubt, resulting in a tenuous hold on the mantle of leadership.

There are compelling examples of this pressure, both in politics and in business. In the United States, presidents feel obliged to think about their agenda for the "first 100 days" of their administration, and to document real achievements during this window to bolster and maintain credibility—even though, unlike business leaders, they are allotted a predetermined four-year term in office in which to reach their goals. One could argue that this pressure is even worse for members of the House of Representatives, who face election every two years; the conventional wisdom is that politicians in those jobs are enmeshed in a continual campaign for office, which is why it's so difficult to implement legislation that achieves long-term changes. In 1957, John F. Kennedy won a Pulitzer Prize for *Profiles in Courage*, a collection of biographies of eight US senators who took actions that went against the wishes of their party and the people who elected them—acts that put the long-term considerations of their country above the short-term needs of their political careers. Even though the book is now more than 50 years old, it's telling that most of the figures profiled served during the 19th century; today, it's hard to imagine politicians making such choices.

Compare these roles with the pressures facing two very different business leaders. When the Apple executive Ron Johnson was tapped to run J.C. Penney, he created an ambitious, long-term plan to dramatically revamp its pricing strategy and store layouts. It's impossible to know if the strategy would have worked because the short-term results were so dismal that Johnson lost credibility, not only with investors and directors but also with many of his employees inside the company, which resulted in his resignation. Contrast his experience with that of Jeff Bezos, who has had a remarkably successful run at Amazon, during which the company continually shows meager quarterly earnings because of large reinvestment into new lines of business, such as cloud services, streaming video, and smartphones. Unlike Johnson, Bezos has earned the confidence of employees (and many investors) based on his 20-year track record and his status as Amazon's founder. But his example begs the question: Could a nonfounder who entered Amazon in 2015 inspire enough confidence that constituents would allow him or her to make such bold, long-term bets? Or, like Ron Johnson at J.C. Penney, would the inevitable decline in short-term results chip away at his credibility and others' willingness to follow him?

Sometimes the pressure to rack up short-term gains comes from the leaders' own followers. I recently spoke with an executive at a company whose CEO had asked her to leave a highly visible role leading the core business of the company to help launch a risky new business. In this case, the CEO had gained enough credibility over the first few years of his tenure to allow him to stop worrying excessively about the new venture's short-term results. As he tried to cajole the executive into moving from the main business to running the start-up division, she balked. "I know you're thinking long term, but if this doesn't work out you still get to run the entire organization," she said. "I'm in a different position—I feel like I need to put points on the board in the next two or three years to move ahead in my career." Ultimately, the CEO convinced the executive to take the leap, but it's an example of how even a leader with a long-term focus can be hampered if he cannot win the confidence of employees, many of whom believe they need to post short-term wins to advance in their careers.

Whether it's politicians or business leaders, the license to continue to lead can depend on the support of others who may have more short-term interests and goals. The need to bring others along is another form of social and psychological pressure that can push leaders to be more oriented to the short term.

In the classroom of the future, more lectures may be delivered online, like the one this professor is preparing. Leaders for the long term must resist the tendency to ignore such potential disruptors.

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LEADERS NEED A LEGACY (But It's Easier To Be Forgotten)

The third psychological issue I see that drives CEOs to focus on short-term accomplishments is their desire for a legacy. Legacy is an interesting issue in management, because business suffers from a short attention span and holds limited interest for historians. In politics, a leader who leaves office can take solace in the fact that the long-term assessment of his or her accomplishments will be

> In business, unlike in political or national histories, even monumental achievements can be quickly forgotten.

refined over decades (or even centuries), and that leaders who are held in low regard when they leave office can sometimes see their reputations burnished over long periods of historical reevaluation. In the United States, Harry S. Truman and George H.W. Bush are two leaders who've experienced this.

In business, this reexamination of legacy rarely happens. Convention, corporate-governance rules, and best practice compel leaders to completely exit the stage when they leave office (it's become uncommon for outgoing CEOs to retain a board seat, for instance). Once they do, they are quickly forgotten. While writers do compile histories of a few iconic business leaders (such as Walter Isaacson's biography of Steve Jobs), this is unusual. Stop and think for a moment how many CEOs you can recall from the 1970s or 1980s. Last year I had planned to refer to Lee Iacocca in my commencement address to graduating students, but someone who read a draft of my remarks warned me that today, more than 20 years after Iacocca's retirement, many MBA students may have no idea who Iacocca is. In business, unlike in political or national histories, even monumental achievements can be quickly forgotten.

Against this backdrop of the difficulty of leaving a lasting legacy, it's only natural for business leaders to want to manage in a way that allows them to enjoy the fruits of their efforts during their time in the job—and to make decisions that make the company successful now, while they're leading it, instead of tomorrow, when hardly anyone remembers that they ever led it. By the time CEOs deliver their retirement speeches, it's natural for them to want to have done something that's already established their legacy—otherwise, they are unlikely to get any credit for it.

These internal, psychological forces that drive CEOs to favor the short term over the long term have at least one similarity with the external, capital-market forces that are usually described as the primary driver of short-termism: they're a set of forces that are extremely difficult to counteract. But they are worth keeping in mind as we diagnose the causes of the growing managerial myopia. Managerial time horizons are certainly influenced by incentives and compensation, by the loud criticism of activists, and by the real pain (or anticipated pain) that occurs when a company misses earnings and its stock slides. But there are quieter, less celebrated, more psychological forces at work here as well—and trying to better understand them can be a useful step in trying to design smart counterweights.

FIRST STEPS FOR LONG-TERM LEADERSHIP

I'm afraid I'm going to be long on diagnosing the problem and short on recommending a solution. But let me offer two parting thoughts that I hope will stimulate further thinking about counterweights to the forces that lead to short-term behavior. Neither of these thoughts is original; they are both borrowed from people I admire for their wisdom and long-term perspective.

The first is from Jim Champy, author of *Reengineering the Corporation* and a wonderful adviser to many business leaders. He makes the distinction between thinking left to right (which most business leaders do) and thinking right to left (which he argues can be more productive). What the distinction means is that even though most leaders have an end goal in mind, they start by focusing on immediate issues and then think about how to get from here to there (left to right). Jim recommends instead that leaders think more carefully about what would have to be true to accomplish their long-terms goals, and then think backward about what they need to begin doing today to realize this goal (right to left). For example, one way to try to double revenues in ten years would be to focus on the current business and determine how to grow it aggressively (left to right). Another way is to recognize that achieving this goal will require the company to build a new or adjacent business about half the size of the current business (because the existing business simply does not have enough headroom to double, even if it grows faster than the competition). This realization, which comes from disciplined right-to-left thinking, gives a leader the insight to focus not just on growing the existing business today but also on investing in building a new one.

To bring this idea home to our situation in business education, when I became dean, my initial focus was primarily on strengthening our 100-year-old MBA program. I didn't pay much attention to online education, even though I was asked about this potential threat many times. But after listening to a talk by Anant Agarwal, founder of edX, I remembered Jim Champy's advice and asked myself: What's your best guess of how significant online education will be in higher education ten years from now? My conclusion was that although I was confident that intense, immersive, in-residence programs like our MBA program would still be around, online education would be at least 25 percent—or perhaps much more—of the higher-education landscape. By thinking right to left, it became obvious to me that I could not ignore the promise and peril of online education—that it represented an opportunity to carve out a leadership position and avoid a potential threat. Thinking right to left is no guarantee of long-term success, but I think it at least increases the odds of taking successful long-term actions.

The second idea comes from an interview with Jeff Bezos in the *Harvard Business Review*. When asked about other CEOs he admires, he offered a list of people he characterized using a nautical metaphor: that they are "deep keeled." By that, he meant leaders who have a strong inner directedness that allows them to stay sure and steady, even as they are buffeted by daily external events. I think deep-keeled people are akin to those who have been described as having a clear moral compass, which helps them, as Bill George puts it, to stay focused on true north. It is certainly easier to stay focused on the long term if you have a deep sense of purpose and an abiding set of deeply held values. Leaders with a deep keel can help those in the boat not get too caught up in the storm; they can ensure that the crew stays focused on sailing to a safe destination. Rather than let other people's anxieties take over, they calm those around them through their own self-assurance. They are less worried about legacy and how others will remember them because they act from a sense of calling and how they will remember themselves.

It is certainly easier to stay focused on the long term if you have a deep sense of purpose and an abiding set of deeply held values.

Getting business leaders to focus more on the long term will undoubtedly create a healthier and more robust economic system. It will require significant attention to and changes in the external system in which business leaders operate. But it will also require a deeper understanding of the internal pressures they face and how those might be attenuated. It will require both leaders and their constituents to develop their own deep keels, so they can define important long-term goals and stay the course to achieving them. ■

Solving Problems That Matter

It's only by doing business with purpose that we can rediscover the real purpose of business.

Paul Polman is chief executive of Unilever. He also serves as chairman of the World Business Council for Sustainable Development, is on the board of the United Nations Global Compact, and is a member of the International Business Council of the World Economic Forum. He was a member of the UN High-Level Panel of Eminent Persons on the Post-2015 Development Agenda. Polman earned a BBA/BA from the University of Groningen, Netherlands, and an MA in economics and an MBA from the University of Cincinnati.

Winston Churchill once famously observed that democracy was the worst form of government—apart from all the others that had been tried. If he were alive today, he might say the same about capitalism as an economic system. For all its failings, no other system has approached its efficiency in bringing unprecedented growth and prosperity to billions of people. Capitalism is the best we have at marrying solutions with needs, funneling capital to worthy ideas, and matching people with necessary work.

But the "best we have" is no longer good enough, as capitalism is also failing us on many levels. The system has deep flaws, both in theory and in outcomes. Perhaps the core failing is an inability to deal with what economists call externalities—those impacts, sometimes positive, but also dramatically negative, that fall outside the marketplace. Pollution is the classic externality, but that's only one example of a general disregard for the critical assets the planet provides to society and economies (mostly free of charge).

The failings of our current system also include a range of other ills: a consistent bias against the future through the use of discount rates that make future benefits worthless and a general obsession with short-term performance; an inability to put numbers on things that are clearly valuable to society and business, such as people's skills and knowledge; and a focus on maximizing growth above all else.

The outcomes of these structural deficits are predictable. On the environmental side, growth has come at an enormous cost, and as a result, we're now pushing the limits of what our planet can sustain. We're depleting our inventory of critical natural resources, from a stable climate and abundant clean air and water to rich stocks of food, fiber, and minerals. These things are not "nice to haves" or luxuries but critical assets for a thriving society and economy. We're at the precipice—or already over it—of what the latest science warns will be "severe, pervasive, and irreversible impacts for people and ecosystems."[1]

As the world heads toward what may be as many as 12 billion people by the end of the century, all aspiring to a higher standard of living, something profound needs to change in how we live, eat, get around, and do business.[2] This has become the core question of our times: How can we provide prosperity to billions more people without undermining the ability of the planet to support us?

Business, run in new ways, will be a critical part of the answer.

To change how and why business operates, our leaders need to make a fundamental shift in both strategy and tactics.[3] This new form of responsible capitalism must go well beyond traditional definitions of corporate social responsibility or sustainability. Businesses must shift their focus from satisfaction with a simple license to operate to creating a *license to lead.*

We need to change our focus to real, long-term value creation, not just quarterly earnings. This new vision will allow business to serve the needs of citizens and communities with the same vigor with which it has served the needs of shareholders over many years. And it will allow business to see itself as a part of society, not separate from it.

With the right lens, we can see clearly that it has always been absurd to treat environmental and social issues as a subset of the business agenda. It's obviously the other way around: business is a part of society and one of its most important expressions. There is no conflict between serving shareholders and serving citizens. Shareholders are part of society too.

But as we take into account all of society's needs, we face a big challenge. Our collective hurdle: a lack of trust.

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RESTORING TRUST IN BUSINESS THROUGH PURPOSE

Business, and the capitalist system it is part of, is in most regards amoral, at least as currently practiced. Capitalism will optimize many outcomes but will generally do so regardless of the larger implications. We can use the tools of capitalism to maximize production of cigarettes or nuclear weapons as well (or as poorly) as we can produce apples or affordable healthcare. In a perverse way, there is a kind of trust that stems from being predictable: citizens can count on business doing whatever it can to maximize short-term earnings at the expense of greater well-being and even a company's own longer-term interests.

Rebuilding trust will require business to change in both principle and deed. Our core operating values must include new commitments to the larger world, such as the following:

- **A sense of larger purpose.** We must bring to bear all aspects of ourselves and our organizations, combining the powerful business tools of the "head," such as analysis, structure, and efficient management of capital of all forms, with the "heart," including the passion and creativity that business uses to solve problems and inspire people.
- **Transparency.** We must be transparent about all aspects of the way we do business—everything from adherence to the UN Guiding Principles on Business and Human Rights to what goes into our products to the way in which we contribute more broadly to operating in a responsible and sustainable

way. This kind of openness will go a long way in helping to restore trust.

■ **A longer-term perspective.** We must have a perspective that does not sacrifice the greater good on the altar of short-term profit. In a world where the majority of stock shares are bought and sold in milliseconds, and with relentless pressure on public companies to perform on a quarterly basis, this last principle is particularly challenging.

To bring these core principles to life, I suggest that companies focus on a few areas:

First, business leaders should set bold goals based on science, such as the dire need for the world to control carbon emissions very quickly. Progress toward those goals should be measured against external thresholds, benchmarks, and realities. Such metrics, openly tracked to build accountability, promote a deeper understanding of and ability to manage our impact up and down the value chain.

We must have a perspective that does not sacrifice the greater good on the altar of short-term profit.

Achieving these goals will often call for effective partnerships, even radical collaborations across traditional lines. Our problems have become enormously complex, and neither governments nor business nor nongovernmental organizations have shown the ability to tackle them alone. We must work together to create solutions.

These principles and tactics create more transparency and trust in a company's actions. They represent a better path but also a clear choice. We can bury our heads in the sand, hoping that the storms of rising public indignation will pass. Or we can make a conscious choice to, in the words of the poet Robert Frost, take the road "less traveled by." We can choose to be givers and not takers from the system that gives us life in the first place.

Unilever has by no means figured out all the answers, but the company has chosen a less traveled path. We call this the Unilever Sustainable Living Plan (USLP).

UNILEVER'S APPROACH AND BUSINESS BENEFITS

We have set a clear and audacious goal to double the size of the company while reducing our environmental footprint and increasing our positive social impact. This effort requires a total value-chain approach, from sustainable sourcing to sustainable living. It has never been tried before by a company of our scale.

The USLP was founded with three big objectives in mind. By 2020, we want to help more than a billion people take action to improve their health and well-being, halve the environmental footprint that results from making and using our products, and enhance the livelihoods of millions of people across our supply chain.

Underpinning these goals are more than 50 specific, time-bound targets.[4] And we are making real progress. We've added around €10 billion to our revenues, growth that is directly supported by the USLP. The brands that we've invested with a sense of purpose and tied to larger challenges in society have been growing, in some cases, at twice the average rate of the rest of our portfolio.

We've also lowered costs by more than €300 million through a range of initiatives, including cutting resource use and moving all factories to zero nonhazardous waste to landfill. And we're reducing the risks from extreme weather and climate change by shifting to more renewable energy, including a commitment in the United States to reach

100 percent renewable power by 2020, following the lead of our European operations, which have already hit this mark.

We're making our supply chains more resilient and stable by working with smallholder farmers to improve farming practices and livelihoods. We have already helped or trained more than 570,000 additional smallholders, from tea farmers in Turkey to vanilla farmers in Madagascar.

Commercial agriculture drove more than 70 percent of tropical deforestation in the period 2000-2012, contributing to ecosystem service loss and climate change. So we're tackling the contribution that the commodity supply chains we rely on make to deforestation. Our commitment to 100 percent sustainable sourcing has galvanized significant change in our sourcing and purchasing patterns.

However, the wholesale transformation of supply chains towards more sustainable models is needed. As the purchaser of 3 percent and 1 percent of the world's palm oil and soy respectively, we are committed to playing a major part in this transformation, working in partnership with our industry peers, governments, civil society and the people who live and work in the world's forests. This change is gathering momentum. At the UN Secretary General's Climate Change Summit in September 2014, more than 170 entities, including businesses, governments, states, provinces, NGOs and indigenous leaders committed to halving deforestation by 2020, ending it by 2030 and restoring 350 million hectares of degraded forest.

The USLP is also helping us to motivate and attract the best talent. Employees are highly engaged by our efforts to make sustainable living commonplace as they look increasingly for meaning at work in a turbulent world. We are now, for the second year running, the third most "in demand" employer among jobseekers on the global networking site LinkedIn, behind only the technology giants Google and Apple. Not bad for a "soups and soap" company that dates back 130 years. People come to us and stay with us in large part because of our purpose, and they demand that we live up to our goals.

Real transformational change is only possible with new and innovative partnerships. We have to act together to address challenges as large and complex as climate change, inequity, or poverty.

UNILEVER'S PROGRAMS AND BRANDS

All these business benefits stem from a concerted effort across the company to bring the principles of responsible capitalism to every part of the business. We have had significant success both building our business and helping solve larger global challenges. The work we did with our Lifebuoy soap brand provides a good example of how this commitment plays out.

It is morally repugnant that millions of children die before their fifth birthday, including two million from easily preventable diseases and ailments like diarrhea. That's the equivalent of a jumbo jet of children crashing every hour, every day.

The most basic of health practices, hand washing, can significantly reduce the number of deaths. Lifebuoy soap, one of Unilever's oldest and proudest brands, has made awareness and practice of hand washing a mission. We employ the only known PhD in the world with a specialty in public health and hand washing.

Our programs have already reached millions of people across Latin America, Africa, and Asia. Just a single event, Global Hand Washing Day, touches 200 million people in 100 countries. These efforts are working—in one of the poorest areas of India, Thesgora, the incidence of diarrhea among children fell from 36 percent to just 5 percent.[5]

The work has also been remarkable in driving the success of the Lifebuoy brand and business. Lifebuoy created a beautiful video featuring an Indian boy surviving to age five that has reached tens of millions of viewers on YouTube. The Facebook page for Lifebuoy has more than four million likes—for hand soap! And this 120-year-old product is now one of the company's fastest-growing brands.

Contrary to what some in the financial markets would have us believe, putting a larger purpose at the core of doing business is not at odds with corporate structures or legal requirements.

NEW ROLES AND NEW WAYS OF WORKING

There is good business in all of this. Without enough water, energy, or hygiene, the communities we operate in cannot function. Business cannot thrive unless the planet and society thrive as well. While there is a lot we can do—and are doing—the challenges are too big for any one organization to solve alone. Real transformational change is only possible with new and innovative partnerships. We have to act together to address challenges as large and complex as climate change, inequity, or poverty.

The relatively small pool of multinational CEOs and corporate leaders provides an unusual opportunity to promote deep change. These roles come with serious responsibility. We have leverage to change the way business and the world work; the largest 200 public companies alone have revenues of more than $20 trillion, or 29 percent of the world's economic output.

As one of these CEOs, I've had the opportunity and privilege to bring the leverage and reach of Unilever to bear on a number of important initiatives. These programs are opportunities to help shape the policy environment.

Many in business seem to have lost track of why companies exist in the first place. At its most basic level, a company is meant to solve a problem for a customer. But taking that beyond face value requires putting a moral, purpose-driven center at the heart of that quest. A company should not fill just any need; it should fill the ones worth filling and the ones most needed. It should solve the problems that already exist, not create new ones.

Contrary to what some in the financial markets would have us believe, putting a larger purpose at the core of doing business is not at odds with corporate structures or legal requirements. Fair returns to shareholders are more than fine; they're desired. The companies with the most resources can do the most good. But those returns are an outcome, not a goal. There is more to business than just profit maximization, but the path of responsible business is a profitable one.

Purpose-driven business creates private value for companies, but it creates much more value for a combination of itself *and* society. Business does not stand apart from social or environmental challenges but is an integral part of the fabric of society.

In this volatile and transparent world, the organizations that work to solve the greatest challenges in partnership with their peers, communities, employees, and customers will thrive. Responsible organizations will outcompete their more self-centered and short-term-focused peers, addressing increasingly complex challenges for all—in essence, finding the ultimate purpose of business: filling a need and profiting from doing so.

We are in the most important time in human history, an era in which we will discover if we're able to come together to manage our shared challenges and build a prosperous world. The *Financial Times* summed up well the plight we face when it argued in a recent column: "A globalization that enriches the richest and impoverishes the rest is not sustainable. The case for open, inclusive societies has to be remade."[6] Business can and must take the lead in these efforts, but corporate leaders need to view their role differently. They have to remake the case for open, inclusive societies.

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Those companies that fail to see that business has a much larger social purpose and value than making money will struggle to survive. Society will reject them. But in the proper hands, the purpose of business can move beyond just private financial gain. We can be a real force for good, helping the world and its peoples prosper in every way possible. ■

[1] *Climate Change 2014: Mitigation of Climate Change*, Intergovernmental Panel on Climate Change and Cambridge University Press, 2014, ipcc.ch.
[2] Robert Kunzig, "A world with 11 billion people? New population projections shatter earlier estimates," *National Geographic*, September 18, 2014, nationalgeographic.com.
[3] We look to many helpful models of a new path, including one outlined by Unilever adviser Andrew Winston in his book *The Big Pivot: Radically Practical Strategies for a Hotter, Scarcer, and More Open World*, Boston, Massachusetts: Harvard Business Review Press, 2014.
[4] According to analysis by pivotgoals.com, Unilever has 20 goals that are consistent with science and aggressive enough to meet the environmental and social requirements of sustainability. Of the world's largest companies, the next-closest organization has 10 such goals, and most have none.
[5] Hindustan Unilever claim based on research conducted by The Nielsen Company in September 2013: 1,485 households with children aged below 12 years, across 11 villages (six test groups and five control groups).
[6] Philip Stephens, "Scotland independence vote exposes the established order," *Financial Times*, September 18, 2014, ft.com.

Generational Thinking at Cargill

At this family-owned company, long-term planning means looking ahead 30 years or more.

Whitney MacMillan was CEO and chairman of the board of directors of Cargill from 1976 to 1995.

Greg Page served as Cargill's CEO from 2007 to 2013 and is currently executive chairman of its board. He also serves on the boards of Eaton, Carlson, and Deere & Company.

Taking the long-term view has always been the Cargill way. In 1939, Cargill set out to find a more efficient way to ship grain along the Great Lakes and the Erie Canal. Cargill leaders believed they could create a bigger and more stable vessel by lashing barge and towboat together with steel cables. On its first voyage, the newfangled barge sank. Still convinced by their basic premise, they tweaked the design, eventually creating the Carneida barge, which was considerably cheaper to operate and made the canal more easily navigable. Thanks to the willingness of those leaders to take risks for the long term, Cargill was able to lower costs and gain a competitive advantage. The Carneida also gave Cargill entry into the shipping business, fulfilling the vision of Cargill's second CEO, John MacMillan Jr., of managing the movement of grain in an "endless belt" from farm to final buyer.

That story is an excellent illustration of the willingness Cargill has always had to set ambitious goals and stick with them, even through setbacks and tough times, recognizing that a prosperous future requires bold investment in the present. In recent years, many business articles have been written about privately held companies and their perceived advantages, from unique culture and values to a freedom from quarterly earnings targets. A 2008 McKinsey survey of UK directors cited greater engagement of directors on private-company boards.[1] *Forbes* noted that its roster of America's biggest private firms outperformed the S&P 500 in 2012.[2] And the 2014 Edelman Trust Barometer shows that consumers throughout the world trust privately held companies slightly more than publicly traded ones, and they trust family-owned companies even more. There is no doubt that Cargill has benefited from those advantages.

The purpose here is *not* to provide specific opinions about organizational structure, or even to suggest that private, family-owned companies such as Cargill are preferable to other forms. While we like how our family-ownership model has evolved, we know that business strategy and leadership are fundamentally about making good choices and that such choices could be made within any organizational structure. Our goal is to show how the kind of long-term thinking that led to breakthrough innovations like the Carneida barge continue to guide Cargill and contribute to its success.

We know from our experience running Cargill and serving on boards of public companies that the allocation of time is very different at a family-owned company. As CEOs, we did not have to interact with stock analysts on Wall Street or sometimes-contentious shareholder groups. Nor did we have to concern ourselves with stock-price movements in the market or the detailed filings with the Securities and Exchange Commission that are required of public companies (though there are still many filings required for private companies of our size). That's not to say there is always unanimity in a family-owned company; it is just to underscore that the amount of time spent with family owners as opposed to public shareholders is different.

In and of itself, long-termism is not a panacea. Let's face it: deploying talent and assets in smart ways that allow an organization to be more agile and adaptable to change is the primary ingredient for any organization to grow profitably.

The allocation of time is very different at a family-owned company. As CEOs, we did not have to interact with stock analysts or sometimes-contentious shareholder groups.

So what has shaped Cargill's long-term view, and what have been some outcomes?

INVESTING FOR THE LONG TERM

Cargill, for one, has always invested with the long term in mind. In particular, it has invested in systems and networks that can improve operations, even amid significant year-to-year volatility. A broad understanding of our supply chains and of businesses associated with the delivery of food has led us to invest in ocean transportation and energy, for example, as well as financial and risk-management businesses to better serve customers and manage our own risks.

We've also aggressively pursued geographic diversity over the past 40 years. The reality is that having broad supply chains—despite some short-term meteorological and political challenges—has enabled longer-term stability. The ability to source grain and oilseeds from other parts of the world when the American Midwest faces drought helps to smooth the impact the company might feel if it were totally dependent on a more confined geographic footprint.

Something like 85 percent of all food consumed is consumed in the country where it is grown—and Cargill is a big player in the other 15 percent of the market, in which food is moved from places of surplus to places of shortage. But to grow as it has, the company has had to expand beyond its base in North America and Western Europe. Cargill has been served well by early investments in Asia, Eastern Europe, and South America.

Investing globally has sometimes required us to navigate geopolitical unrest and to be somewhat patient as emerging markets developed. After the fall of the Berlin Wall, the number of free-market economies in the world increased significantly. For Cargill, that meant access to a lot more people with demand for more and better food. Because of earlier investments in the region, we were well positioned to serve those new markets. Our cottonseed operations in East Africa and our cocoa operations in Côte d'Ivoire and Ghana have at times been challenged by civil unrest and other complications. But persistence has allowed us to remain among the largest suppliers of high-quality cocoa beans to some of the world's top chocolatiers.

Hyperinflation and political challenges through the years in places like Argentina and Venezuela prompted us to think about how we might remain a reliable supplier to our major customers and help them thrive in markets with potential. As a result of our global mindset, we have often been better poised to make investments for the future when politics shift. After the passage of the North American Free Trade Agreement, for example, we were able to quickly invest in a new soy oilseed-processing plant and refinery near Tula, Mexico. This facility uses both imported and local inputs for domestic distribution and export and has allowed Cargill to profitably expand its market share in Mexico.

The Carneida barge, based on a new design, created long-term value by making it easier to ship grain through the Erie Canal.

COURTESY OF CARGILL

CULTURE AND CORE VALUES

One feature of many long-standing and successful family-owned and privately held companies is their strong core values, often articulated early in their development. Bechtel and Mars, for example, are both guided by principles that were laid down by early family members. Cargill is no different. Our second leader, John H. MacMillan, once said, "Our word is . . . our bond." Faced with a major financial challenge upon the death of his father-in-law and company founder William Wallace Cargill in 1909, MacMillan, convinced bankers to give him time to settle the company's debts and sell off assets. In less than seven years, he not only made good on his promise but also built a growing grain business that set the stage for the company we know as Cargill today.

Cargill has formulated seven guiding principles under which all company policies fit. These principles, which follow, serve as a guide not to *what* we do but to *how* we do it:

1. We obey the law.
2. We conduct our business with integrity.
3. We keep accurate and honest records.
4. We honor our obligations.
5. We treat people with dignity and respect.
6. We protect Cargill's information, assets, and interests.
7. We are committed to being a responsible global citizen.

COMMITMENT TO EMPLOYEES

While Cargill is not perfect, we know that we only achieve our goals through our people. As a consequence, we work hard to provide a safe workplace and to value the unique contributions of our global team. The conscientious treatment and development of our employees has led to a steady influx of talent and to greater continuity in our workforce than might be found at other companies.

This continuity no doubt has been helped by the company's growth. Given Cargill's growth in size and geographic reach, we've been able to provide multiple career paths to our top talent, all within one overall Cargill career. That stability of the broader workforce is reflected in part by stability at the top. Professor Michael Jarrett, who is affiliated with INSEAD, wrote in November 2013 that the average tenure of a Fortune 500 CEO is about 4.6 years. Cargill has had nine top leaders in 149 years and six in the past 54 years.

CUSTOMER FOCUS

As our customers have grown, so have we. As they have thrived, so have we. As many have looked to grow into new markets through the years, they have approached Cargill, as a trusted supplier, to support those efforts in new parts of the world.

In the 1990s, we invested in Russia's largest corn wet-milling plant in Efremov, an industrial town 240 miles southeast of Moscow, to support the growth strategy of Mars. The plant produced glucose sweetener, dextrose for fermentation applications in Russia's pharmaceutical and vitamin industries, and corn-gluten meal for livestock feed. The facility presented challenges, requiring a good deal of time and effort to get it in shape to meet Cargill quality and safety standards and to retrain the workforce. While it took some time to get the facility up to our global standards, we later posted annual earnings that exceeded return expectations. The plant today supports many other customers and businesses and has grown in size and purpose.

In the last few years, we have made a significant investment in poultry operations just outside Chuzhou in Anhui province in China to serve the growth needs of American-based food-service retailers in China and have built a state-of-the-art integrated chicken-processing facility with the capacity to process nearly 65 million birds a year. While this plant has yet to recover its steep investment, it too is growing alongside customers who know the special care Cargill has taken working with Chinese food-health and safety officials to produce safe, nutritious chicken.

GOVERNANCE

How we have governed ourselves also has mattered. As a private company, we don't face activist shareholders or the same regulatory frameworks that public companies must cope with. That has allowed the Cargill board of directors to be agile in its approach to strategic development.

One obvious advantage is that the family operates more cohesively than independent shareholders in a public company. Our owners, for example, are dedicated to reinvesting 80 percent of earnings back into the company. This provides Cargill with the luxury of being able to invest a large proportion of earnings each year in acquisitions, plants, equipment, and innovative products and services. As we grow profitably, we have more to reinvest and greater ability to leverage our position with debt to further finance innovation and investments that fuel growth. This ability has been a necessary precursor to our ability to take a longer-term view and invest in the future.

Family shareholders, senior management, and external board members at Cargill talk of "patient capital." There are actually three Ps that are fundamental to our investing philosophy: private, permanent, and patient. As a private company, we are willing and able to make investments for growth when opportunities arise, even when the rewards may not materialize in the near term. Indeed, it is not unusual for us to continue to invest straight through an economic downturn (as we did in recent years), when the tendency in some organizations may be to rein in expenditures. The family mind-set toward the capital it places in the company is that it is permanent. It views that capital as a vehicle for intergenerational wealth creation. Permanent, however, does not mean that we will not shed underperforming assets and businesses; we do and we will. But because we tend to think of our investments as a way to support the next generation of family owners, there is some thought as to managing our portfolio investments with a 30-year time horizon or a generation-and-a-half period. When we say "patient," we do not mean complacent; rather, we recognize that many of the investments we make are cyclical in nature and that there are strategic reasons (competitive advantage, logistics, and geographic diversity, among others) that may prompt us to accept smaller short-term returns with the calculation that the returns will be at or better than hurdle rates over a longer period.

OUR BROADER PURPOSE

The last of our seven guiding principles reads, "We are committed to being a responsible global citizen." When we grappled with trying to define our strategic intent for our private, global company in the early 1990s, raising living standards around the world by delivering value to producers and consumers was one of the company's stated aims. In some ways, our long-standing cause has been about nourishing people. The family owners of the business feel a deep sense of responsibility for the company and its continuity; a corollary of this is that these owners want not only to see the company operate profitably but also to do good and serve the family name proudly.

This has prompted Cargill to consider the long-term implications of its business for indigenous populations as it branches out, to take special care to minimize its impact on the environment, to commit to leadership in the areas of food safety, and to work with public-policy makers and nongovernmental organizations toward food security for the people of the planet. While an organization the size of Cargill cannot always avoid criticism or controversy, we depend on our values to guide our actions. We also know that many of our best customers are committed to these issues as well. Many of the public companies we work with have long shown admirable foresight and sounded the trumpet for environmental sustainability and responsible supply chains.

The Iroquois Nations' constitution told its followers, "Look and listen for the welfare of . . . the coming generations." As a family-owned company, we've tried to do the same. Indeed, one Cargill family member some years ago commented, "My father said that if I take care of the company, it will take care of me."

Just as we might have some advantages that lend themselves to longer-term thinking, we still need to make smart decisions. We cannot afford to let the long term provide us with an excuse for underwhelming performance in the near term. Indeed, the challenge for any organization is to achieve optimal performance over time, which requires both thinking about tomorrow and executing in smart ways today.

When Cargill's board, its executives, and its family owners talk about the company's portfolio, we talk about it in the context of being resilient, balanced, and diverse. Thankfully, for nearly 150 years, we have done just that. ■

[1] Viral Acharya, Conor Kehoe, and Michael Reyner, "The voice of experience: Public versus private equity," December 2008, mckinsey.com.
[2] Andrea Murphy, "America's largest private companies 2012," *Forbes*, November 28, 2012, forbes.com.

Chanda Kochhar

Long-Term Planning In a Volatile Environment

Political upheaval, economic crisis, disruptive technology—in today's world, it's easy to lose sight of the goals that matter.

Chanda Kochhar is managing director and CEO of ICICI Bank, India's second-largest bank. She joined ICICI in 1984 and led many of its businesses before taking on her current role. She is widely recognized for helping to shape the retail-banking sector in India. Kochhar is a member of the Prime Minister's Council on Trade and Industry and was cochair of the World Economic Forum Annual Meeting in 2011.

The world is changing rapidly, and for business, it is more volatile than ever. The trends that affect it most are often not linear or unidirectional. Instead, there are two-way swings, often large ones, which businesses have to respond to. New regulations, for example, are substantially changing the landscape, particularly in financial services, by imposing constraints but also by creating opportunities and promoting greater competition. Technology continues to transform business models, rendering some obsolete while opening up possibilities for value creation. A new generation of socially networked digital customers is leading to a change in customer needs and preferences. These factors pose significant challenges to long-term planning.

Yet precisely because of this environment of rapid change, long-term planning has become more important than ever before. Without a guiding principle for long-term value creation, organizations run the risk of constantly being blown off course by short-term concerns. The key to success in this volatile world is to anticipate change and formulate and execute responses, both strategic and tactical, in order to build sustainable competitive advantage.

We have experienced these challenges at ICICI Bank over the last five years. I took over as CEO in 2009, when the world had just experienced a global financial crisis that would have a far-reaching, long-term impact. It was a period of uncertainty and volatility. India, our home country, was quick to recover. In the two years immediately following the crisis, we had GDP growth of more than 8 percent, and many of us assumed that we had won the battle and growth was here to stay. But in 2011, we entered a period of prolonged economic slowdown and volatility in financial markets that has lasted three years.

Today, we are in a period of renewed optimism and hope. GDP in India grew 5.7 percent in the June quarter of 2014, the fastest pace in more than two years. Yet challenges remain, and risks—from geopolitical tensions in some parts of the world to persistent domestic economic issues—still have the potential to affect our business. This is in addition to the longer-term structural trends like advances in technology and the possibility of disruptive new business models, as well changes in policy and regulation.

The starting point of long-term planning is to decide where you want to go. The leader's role begins with envisioning the future of the organization and articulating it.

KEY LESSONS

So how does one manage long-term objectives in a world of change and volatility? Here are five takeaways from my experience over the last five years.

1. DEFINE YOUR GOAL

The starting point of long-term planning is to decide where you want to go. The leader's role begins with envisioning the future of the organization and articulating it; then he or she must go on to translate that vision into measurable, time-bound interim objectives. They could be based on the potential of the market, the need to fill gaps in the franchise or to redefine the appropriate financial benchmarks, the need to meet challenges from key competitors, or the need to manage stakeholder expectations.

In 2009, we took stock of our business. We were delivering a return on equity of less than 7.8 percent. We set ourselves a goal of achieving a return on equity of 15 percent, almost double the level we were then hitting.

2. MAP OUT A STRATEGIC PATH

Having defined the long-term objective, it is important to have a sequenced strategy to achieve it. The organization must have a defined path that prioritizes different aspects of the business at different times, based on the progress achieved in the earlier stage.

We set out a three-stage path. The first stage—broadly, the first year of the plan—was a period of consolidation and rebalancing of our funding profile, cost structures, and credit portfolio. We articulated the priorities for this phase as the "4Cs": current and savings accounts (CASA), costs, credit, and capital. CASA represented our goal of strengthening our funding profile and substantially increasing the proportion of checking accounts and retail deposits in our funding base. Costs represented our focus on operating efficiency to improve profitability in a challenging environment for revenue growth. Credit represented our focus on changing the mix of our loan portfolio by reducing unsecured retail loans, thereby bringing credit costs under control. Capital represented our goal of conserving our strong capital position to maintain the strength of our balance sheet.

The second stage was focused on a renewal of balance-sheet growth combined with improvement in profitability, defined as the return on assets through better margins, cost efficiency, and lower credit costs. While staying with our longer-term goal of doubling our return on equity, we redefined the core elements as the "5Cs." The first three—CASA, costs, and credit—remained unchanged; the fourth C, capital, was redefined to focus on leveraging the capital base for growth. A new dimension was added through a fifth C, customer centricity, which involved renewing the promise of our brand to our customers and backing it with changes in organizational structures and processes to improve service delivery.

The third stage was to accelerate growth on the back of the improved funding profile and profitability metrics, and leverage capital more rapidly to improve return on equity.

3. STAY THE COURSE—BUT BE FLEXIBLE WHEN REQUIRED

Challenges to long-term planning come from the world around us. First, companies sometimes feel a sense of lost opportunity when their organization's priorities, as dictated by the long-range plan, require them to forgo some immediate opportunities. Second, changes in the environment sometimes change the assumptions on which the plan is based. It is important to have the strength of will and long-term focus not to be swayed by opportunities for short-term gains that may be unsustainable. At the same time, the organization must be able to adapt the plan to changes in the environment when required.

In the early stages of our plan, we frequently faced the first challenge. While we were focused on consolidating our balance sheet and improving our funding, cost, and credit parameters, the Indian economy had quickly recovered from the downturn of 2008 and was registering strong growth. The banking system was also growing at a rapid pace, and we were losing market share. The temptation for us was to compromise our plan to correct our funding profile and profitability metrics, and then pursue loan growth backed by wholesale funding. However, we understood that this would be unsustainable and hence stayed the course.

It is important to have the strength of will and long-term focus not to be swayed by opportunities for short-term gains that may be unsustainable.

In subsequent years, once we achieved our targets on funding profile and profitability, we were ready to accelerate growth. By this time, however, India was in the grip of an economic slowdown and adverse corporate credit. We therefore decided to calibrate our growth, even though it meant slowing down our plan to leverage capital and improve our return on equity. It was necessary to be flexible and balance growth with risk management in the changed environment.

At the same time, we also identified and leveraged new opportunities. For example, about a year into our plan, we saw the opportunity to accelerate our time to market in building out the retail franchise by acquiring another bank. Acquisitions were not part of our original plan, but when we saw the opportunity, we quickly went ahead and integrated the acquired bank into our business. We created new models in various areas of our business. We created and scaled up a low-cost branch model for serving unbanked villages. We implemented a number of technology initiatives focused on mobility, digitization, and branch automation, to enhance the customer experience.

4. FOCUS ON EXECUTION

Execution is the key to a long-term plan's success. The leader must not only envision the future of the organization, translate it into measurable objectives, and lay out the path to achieving those objectives but also be involved in the execution. The leader must stay in touch with the realities on the ground to ensure that the organization achieves its vision.

In our case, as we executed our plan, we had a regular process of structured reviews on our key target metrics. We focused not only on the numbers but also on the underlying processes and enablers that we wanted to put in place to strengthen the franchise and create a sustainable growth platform. We also regularly took informal checks at the ground level to get a sense of how things were working on the front lines. To this day, I hold regular meetings with employees of various grades, in which I listen to them share their experiences and the issues they face in executing the plan as well as consider the changes they suggest. Regular visits to branches whenever I travel help me get a feel for how well they are functioning. Feedback from both corporate clients and retail customers goes beyond data metrics in helping me monitor the quality of our franchise. All these bottom-up inputs then go into improving the execution of our strategy.

The leader must envision the future of the organization, translate it into measurable objectives, and lay out the path to achieving those objectives.

5. COMMUNICATE, COMMUNICATE, COMMUNICATE

Finally, communicating the plan to all stakeholders is critical to winning their support in achieving it. This starts within the organization—the plan must be explained to the team so that they understand the objectives, buy into the strategy, and execute it flawlessly. It must be explained to investors, so that they understand the organization's approach to value creation. It must be explained to regulators, so that they have confidence in the organization and are not taken by surprise by its strategy and the results of that strategy—particularly in the initial phase of execution as significant changes are made in the organization.

As we embarked on our strategic path, a priority for me was to meet people in the organization at various levels, explaining to them what the new strategy would be and the logic behind the initiatives we were taking. I not only articulated our priorities but also explained how they fit into a longer-term, five-year vision for ICICI Bank, and how they would position us for the next phase of growth. We followed a similar approach with other stakeholders, including investors, regulators, and customers. We also periodically went back to these stakeholders to communicate the results of our strategy and where we were on our journey.

Through this long-term planning process, we did indeed achieve our return-on-equity objective and substantially enhanced shareholder value.

Long-term planning supports true value creation. It positions the business to capitalize on growth opportunities while ensuring not only the desired level of earnings and profitability but also stability and consistency in those metrics. Articulating long-term aspirations, adhering to them, and demonstrating progress in achieving them builds confidence among stakeholders about the resilience of the organization and its ability to achieve sustainable, profitable growth. ■

Kathleen McLaughlin and Doug McMillon

Business and Society in the Coming Decades

Companies have an opportunity to use their scale and expertise to reshape global systems and mitigate the complex problems facing society.

Kathleen McLaughlin is president of the Walmart Foundation and senior vice president of sustainability at Wal-Mart Stores, Inc. Previously, she was a senior partner at McKinsey & Company and director of the firm's social innovation practice.

Doug McMillon is president and CEO of Wal-Mart Stores, Inc. He began his Walmart career in 1984 as an hourly summer associate in a distribution center and has gone on to serve in a variety of roles, including chief executive of the company's Sam's Club business unit and later Walmart's International division, before assuming his current position.

Business exists to serve society.

Over the past several decades, one of the great discussions within capitalism has centered on defining exactly what a business is and what its obligations are to society at large and to the many stakeholders participating in business systems, including customers, shareholders, employees, suppliers, and communities, to name a few.

The obligations to society have been defined in different ways at different points. For many retailers, including Walmart founder Sam Walton, the focus has been first and foremost on serving the customer. For others over the past couple of decades, the focus was myopically on the shareholder. With the advent of shared-value, double-bottom-line, triple-bottom-line, and related movements, we have seen a broadening of the discussion to recognize the importance of multiple stakeholders and the need to promote social, environmental, and financial value.

Long-term capitalism goes one step further, asking companies to actively reshape the systems in which they operate. Those systems could include the complex of logistical and shipping services that move goods around the globe, the web of overseas contract manufacturers on which companies rely, or the array of energy suppliers that fuel worldwide operations. Long-term capitalism takes a deeper view of business's role in society, recognizing that, in the long run, the interests of stakeholders converge with the interests of the broader community. The actions of any one company may reverberate throughout the various systems in which it operates, generating second- and third-order benefits as well as negative externalities. Under long-term capitalism, companies recognize that fact and, through concerted action with others of sufficient scale, work to ensure constant improvements to those systems.

Long-term capitalism takes a deeper view of business's role in society, recognizing that, in the long run, the interests of stakeholders converge with the interests of the broader community.

There are compelling reasons companies should seize the initiative to drive social and business benefits. First, in an interconnected world facing unprecedented environmental and social challenges, society will demand it. Increasingly, a basic expectation among customers, governments, and communities will be that the companies they do business with provide a significant net positive return for society at large, not just for investors. This will be a part of the implicit contract or license to operate.

Second, adding these other forms of positive return and improving systems will make the business more sustainable in the long term. Every company should be able to contribute value to society through its core businesses. By collaborating with other members of their networks and pursuing initiatives that draw on their particular capabilities, they can make society stronger in ways that also fortify their business. There is generally ample scope to do this, even for companies facing near-term earnings pressure, because the overlap between short-term, close-in interests and longer-term, societal interests is almost always large.

THE BASICS: ADD VALUE FOR SOCIETY AS WELL AS BUSINESS

When it comes to serving society, a company's first task is to ensure that its core business is fundamentally value creating—not just for shareholders but also for customers, employees, suppliers, communities, and the environment.

This stakeholder-value principle may seem obvious, especially given the extent to which triple-bottom-line thinking has seeped into mainstream business discourse. Yet financial short-termism still drives day-to-day decision making for much of the corporate world. For many, shareholder value creation remains the driving force of business initiatives; creating value for stakeholders becomes a by-product or a means to an end. Even when faced with reputational challenges, companies sometimes launch social initiatives as side projects only tenuously linked to the core business, rather than strengthening and articulating the ways in which the core business adds value to society.

Taking a more expansive view of serving society means first ensuring the core business delivers value to the broader set of stakeholders. Is it adding value to the local community, for example, through taxes and engagement with local organizations? It also means addressing externalities related to the core business.

At Walmart, that includes trying to minimize the environmental footprint of our operations. Between 2010 and the end of 2013, we reduced our energy consumed per square foot by 7 percent, and we now source 24 percent of our global electricity needs from renewable sources—progress toward our long-term goal of 100 percent. By the end of 2014, we were diverting more than 80 percent of our waste in the United States from landfills through recycling and reuse, on our way to our goal of generating zero waste.

GO BEYOND THE CORE TO CHANGE THE SYSTEM

While it is important to operate the core business in a way that delivers value for society and the business, a healthy, high-performing company can and must go further. The world faces social, environmental, and financial challenges of unprecedented magnitude and complexity. No one actor can resolve these issues single-handedly. Governments and civil society are increasingly calling business to the table.

Meanwhile, globalization and technology have heightened interdependence in our social, environmental, and financial systems. Even seemingly small actions can have serious consequences for others far away in space and time. Globalization and technology have also greatly increased transparency. Actions and their consequences, however far removed, are much more visible to all.

These forces have increased the opportunities—and the responsibilities—of business. If in the past 20 years the discussion has been about the need for business to serve stakeholders beyond just the customer and the shareholder, the next 20 years will be about the need for companies to improve the networks and systems they depend on. Leading businesses are actively using their scale and their particular assets to accelerate progress on tough social and environmental issues.

So, how can companies define their unique contribution to making society stronger? At Walmart, we use five screens.

1. Prioritize Issues That Are Relevant to the Company Mission

Like most companies, we look for those issues that sit at the convergence of our business interests and the interests of society. For example, as the world's largest grocer, we believe the sustainability of the world's food supply is one of the areas in which we can make a significant contribution.

The United Nations projects that food production must increase by roughly 70 percent to feed the estimated nine billion people who will inhabit the planet by 2050. We will need to meet that challenge in a way that is sustainable for the environment and equitable for consumers and farmers (who make up two-thirds of the population in emerging markets). Our goal is to make the food system safer, more transparent, healthier, and more accessible—and to lower the "true cost" of food for the environment as well as customers and farmers.

2. Draw on the Company's Particular Capabilities

Even in purely philanthropic areas, companies can have greater impact by drawing on their unique business capabilities and applying those skills to complex societal problems. In our own efforts, we try to add value in ways that are different from—and ideally additive to—what others can do.

For example, to address hunger in the United States, we make use of our particular assets. Over the past several years, we have donated nearly 1.5 billion pounds of food to food banks across the United States, including an increasing amount of fresh food nearing the end of its shelf life. This improves nutrition among those most in need, while reducing the amount of food we send to landfills as waste. We also donated more than 180 trucks and refrigerated trucks, as well as time and expertise in logistics (since this is an area we understand well), to help strengthen the country's charitable cold chain.

3. Aim for a Triple Bottom Line

In tackling priority issues, we design our initiatives to promote benefits for society as well as business. We set ambitious targets, and we track progress rigorously.

In food sourcing, for example, we pursue initiatives that lower the environmental and financial cost of food production. One of these initiatives, agriculture optimization, aims to reduce greenhouse-gas emissions by eight million metric tons across ten million acres of row crops such as oats and rice by 2020. Similar initiatives in the food chain and our own operations have allowed us to reduce our greenhouse-gas emissions by approximately 18 million metric tons since 2010. To do so, we are working with the Environmental Defense Fund, as well as other large food companies, including Cargill and General Mills, to adjust the use of fertilizer and other inputs. We measure progress by tracking improvements in greenhouse-gas emissions, water, yields, and other critical factors per ton of food produced, by supplier and by category.

In the era of long-term capitalism, companies can and must harness their expertise and scale and join with other organizations to reshape global systems for lasting improvement.

Such initiatives provide classic triple-bottom-line results. Besides the important reduction in greenhouse-gas emissions, they helped us to cut the price of fruits and vegetables in the United States by a total of $3.5 billion through 2012 and 2013, offering important benefits for our customers and improving the world's food supply.

4. Reshape the System for Lasting Improvement

In the era of long-term capitalism, companies can and must go beyond the kinds of improvements described above. They can do this by harnessing their expertise and scale and by joining with other organizations to reshape global systems for lasting improvement.

The global food system is essential to our business. For it and for us to succeed, the system must evolve in a way that is sustainable for the environment and smallholder farmers around the world; the system also must be high-enough yielding to feed a growing world population. Walmart is working to enable that evolution. For more than a decade, we have been collaborating with the US Agency for International Development (USAID) to improve the lives of smallholder farmers and women in the agriculture supply chain. Through our direct farm initiative in Central America, USAID and its implementing agencies have provided agricultural expertise, training, and capital for infrastructure to smallholder farmers, preparing them to sell into the organized retail sector. Walmart provides specifications based on consumer preferences, guidance on timing for different crops and varieties, and regular purchase orders for offtake of farm production. Smallholders gain a better price and more stable income, as well as the skills to improve yields and profitability. Local customers gain a wider variety of better-tasting fruits and vegetables at the time of year when they want to buy. The agriculture sector gains productivity and becomes more viable. In Argentina, for example, more than two-thirds of our fruit and vegetable supply now comes from such direct-farm programs. In our US private-label supply chain alone, we depend upon roughly $4 billion per year in agricultural products from small and midsize farmers.

Now we are exploring opportunities to collaborate with others to strengthen transportation and processing infrastructure in emerging markets. This will help develop local economies, feed local populations, and support local farming families, all while providing a secure supply of high-quality food products for Walmart customers.

5. Engage Partners in Transforming Systems

To achieve lasting solutions to complex social and environmental challenges, we have learned that it is essential to engage and collaborate with other leaders of the systems we seek to strengthen.

The difficult challenges facing the world today are well beyond the scope of any single player to address. Solutions will depend on cooperation among leading organizations in all sectors.

To achieve the magnitude of change the United Nations, World Wildlife Fund, CDP and others have called for in food, such as a reduction in water usage, a 3 percent annual decrease in private-sector greenhouse-gas emissions, and a 15 percent increase in yield in the next ten years, leaders of the food system must take concerted, coordinated action. In recent years, there has been an explosion in the number of multistakeholder collaborations in the food system, including the Consumer Goods Forum, which aligns retailers and manufacturers in achieving global food commitments such as sourcing 100 percent sustainable palm oil and soy; the World Economic Forum, with its Grow Africa and related initiatives; USAID's Global Development Lab, to harness the power of the private sector and others in addressing development challenges; and the Clinton Global Initiative, with its innovative approach to sparking collaborative commitments from corporations, to name just a few.

EMBED THE VALUES IN THE BUSINESS

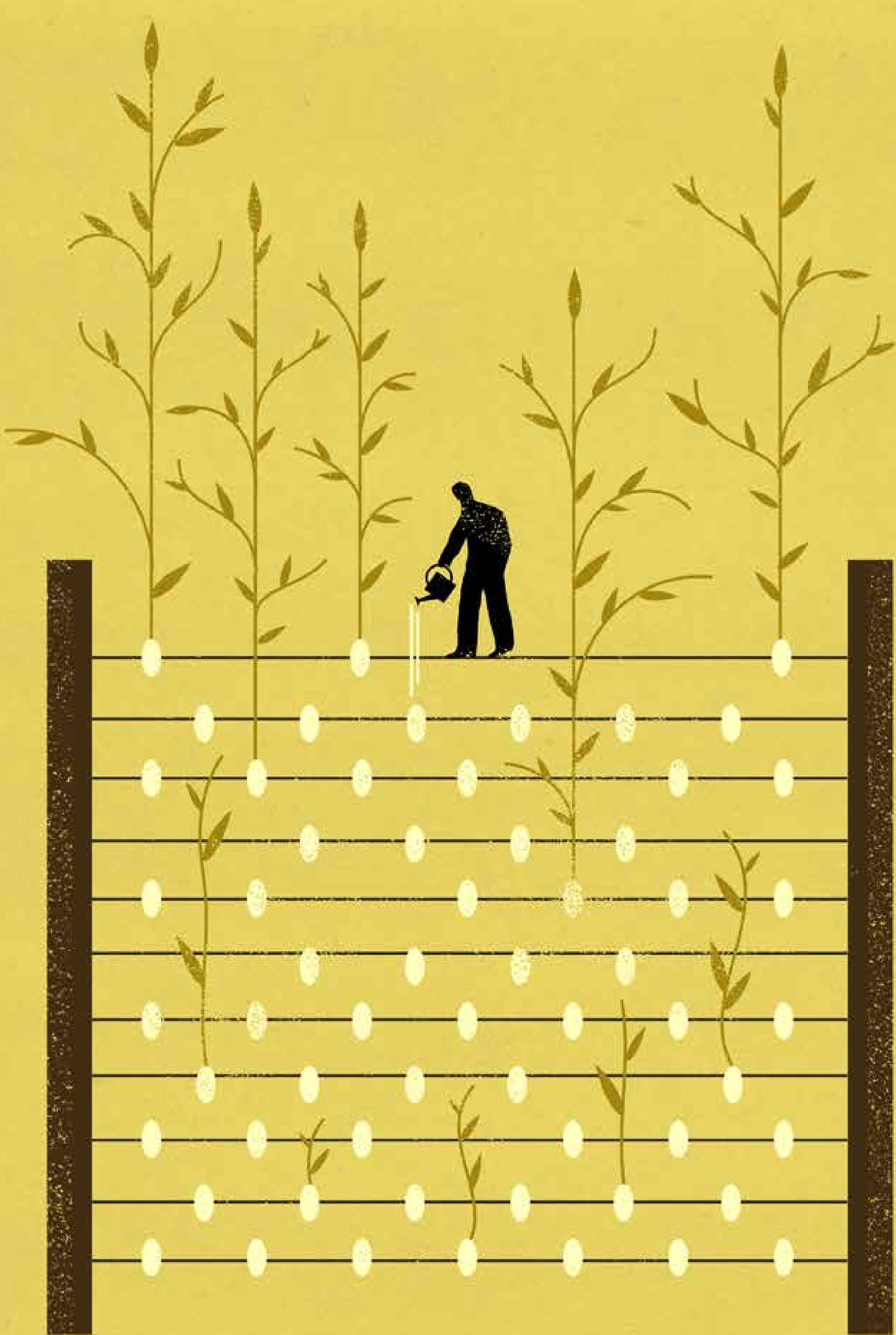
The commitment to address social and environmental issues should be a "whole company" undertaking, woven into day-to-day business activities; it's not just a matter of corporate philanthropy.

Many companies, including Walmart, develop social and environmental priorities as part of annual business-planning efforts. We have made bold, public commitments—for example, to help train one million farmers by 2015 and to source 100 percent sustainable palm oil by 2015. These commitments focus our efforts and force innovation. Many of these commitments are made jointly with suppliers and our partners at nongovernmental organizations.

Leaders in the company, including the heads of business units and functions, set the social and environmental agenda for their respective parts of the operation. They set targets and cascade those down the line into the individual performance evaluations and business reviews of their team members. The capital-planning process explicitly addresses the social and environmental agenda.

In the long term, a company's business interests and the interests of society converge. Companies, communities, individuals, and governments: we are all interdependent. Every healthy, high-performing company has an obligation to use its strengths to help society, and each can do so in ways that enhance the viability of the business, too. From how products are grown and made to how they're transported and sold, companies can pursue innovative new methods and processes that provide lasting benefits to their stakeholders and to the communities in which they operate.

Large-scale change does not happen overnight, but the stakes and potential benefits are immense. ■



INVESTING

An Unshakable Belief in The Long Term

Safeguarding capital for the future generations of a nation should be easy, but our natural human frailties make it hard. Success requires good governance, a principled view of global markets, and the courage to stick with those principles through good times and bad.

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The general nature of the problems that bedevil the long-term investor are explained well and in substantial detail elsewhere. I offer a perspective from the Guardians of New Zealand Superannuation, a New Zealand government entity established to prefund future pension liabilities, on some of these issues in this article. I focus on the view that good governance is the indispensable prerequisite for successful long-term investment.

Earlier this year, I had the privilege of speaking with several Pacific Island University students in New Zealand about their opportunities. For whatever insight I may have provided, I was thoughtfully and generously thanked with some of Auckland's finest baking. Under usual circumstance, gifts received by the Guardians are auctioned to staff at the end of the year, with proceeds going to charity. The cupcakes, however, by virtue of being perishable and valued at under $50 (though I thought them priceless), made their way home that evening, to the appreciation of both my family and Bud, the dog.

Like all gifts and hospitality received by fund staff, the baking was duly entered into a register that was published at the end of the financial year together with the detailed and complete records of our portfolio strategies, investment managers and holdings, performance, compensation, expenses, and other miscellany.

We take full transparency as the default starting point at the Guardians. It forms a bedrock element of governance arrangements that cascade all the way from our founding legislation to the policies that set out delegated authorities, asset allocation, and enterprise risk management. It also infuses a commitment to a culture defined by constructive achievement. Our transparency is intended to mitigate the agency problems that inevitably arise in the management of other peoples' money—problems that are more difficult to resolve the longer the investment horizon.

THE GUARDIANS AS A LONG-TERM INVESTOR

The "long term" means different things to different people, and we have found it essential to sieve through theory and practice to establish consistent thinking on this in the context of our goals, endowments, beliefs, and capabilities. Our deliberations have yielded a distilled view on what it means to be a long-term investor. More importantly, we have asked ourselves if we have the capacity and judgment to take the long view in our own investments and reap the advantages that are available to such an investor.[1] For us, the most useful definition is that a long-term investor is one who can hold any investment strategy for as long as the investor wishes. Therefore, investing for the long term is largely concerned with the ability to control the deployment of risk capital at all times, and especially at times of market dislocation and turmoil. In other words, the long-term investor must have the resources and discipline to resist short-term forces that could cause a deviation from the overarching strategy.

> The long-term investor must have the resources and discipline to resist short-term forces that could cause a deviation from the overarching strategy.

This discipline must be institutionalized. The Guardians are only able to maintain this control because certain institutional characteristics are to the fore: a government and beneficiary that has granted a commercially focused mandate to a board that then independently decides on a desired risk-return profile and investment strategy for the fund; the board's support of management in the execution of the strategy; limited claims on capital; sufficient liquidity; and generally low levels of peer and agency risk.

Before I turn to the links between these characteristics and our governance arrangements, it is useful to summarize the advantages we see in long-term investing. Each is conditional on a particular belief about the nature of financial markets and that of other participants.

One of our investment beliefs is that financial markets are not perfect—short-term behavior is both cause and consequence—implying that there are substantial periods of time when asset prices become unanchored from their fundamental values and that prices do, eventually, return to these values. If the views on the core investment risks that we are willing to adopt do not change with prices or other market developments, then it makes sense for the fund to invest against the market. We look to buy when others panic and sell, and we look to sell when others are euphoric and eager to purchase. Our view allows us to be more levelheaded, to discount short-term manias and panics in equal measure, and to seek long-term profit from these instead.

One consequence of panics and crashes is that when they occur, the market balance between demand and supply tilts overwhelmingly in favor of supply, with most either looking to sell or, as is more likely, being forced to sell to meet their other financial obligations. In anticipation of these times, assets considered easier to sell quickly as the need arises trade at a premium to illiquid assets. A long-term investor who generally does not have other financial obligations that force him or her into selling can benefit from acquiring the illiquid assets that are cheaper because they are less attractive to the general (short-term) investor. Given that a long-term investor can invest in anything that a short-term investor can but is also more likely to consider illiquid assets, they benefit from increased choice and better diversification.[2]

It is in the bad times that our mettle as a long-term investor is truly tested. Happily, this is also when the available advantages can be fully harvested.

The investment markets are characterized by relationships that are distanced and transient. If, instead, we can forge strong relationships with the companies we invest with where all partners are aligned on generating long-term value, then, again, a potentially wider investment universe opens up to the fund. This is an advantage as long as our belief holds that these long-term relationships have the capacity to enhance risk-adjusted returns. Incidentally, secure long-term holdings are also advantageous for the companies we invest in. For example, the natural life cycle of assets such as forests, infrastructure, and unlisted companies gears them toward returns in the long term. Such opportunities may struggle to attract competitive capital from investors with shorter-term investment horizons, making it less likely they will be funded. More generally, confident in the knowledge that their investors are not flighty, investee companies are freed from the requirement to focus on short-term earnings and profits and can instead set sights on defining and executing strategies for the long term.

Finally, at the fund, we characterize investment themes as the long-term secular influences on the global economy that are inexorable and invariant to business cycles. For example, the aging of populations, the warming of our climate, and the urbanization of developing countries are themes that will play out over several generations irrespective of the periodic booms and busts of the global economy. As long-term investors, we are ideally suited to examining the implications and positioning ourselves to invest in opportunities that will only yield returns as the themes mature.[3]

THE ROLE OF GOVERNANCE

Our pursuit of these advantages requires that we identify the right investment strategies and then demonstrate the wherewithal to persist with them during market rallies and declines. Steady hands are of course important during the good times: discipline must be maintained in rebalancing portfolios, in selling when prices exceed valuations, and in resisting competing for overpriced assets. However, it is in the bad times that our mettle as a long-term investor is truly tested. Happily, this is also when the available advantages and a long-term investor's endowments can be fully harvested. Maintaining focus is difficult, and it is human nature to flee to safer shores (and thus dampen career risks). Good governance arrangements, agreed to in advance and relatively immutable, combat these tendencies.

The Guardians use to the fullest extent our enabling legislation, which provides operational independence and a wide investment spectrum. This provides us the confidence to enter into investment arrangements that best suit the fund's long-term purpose, with minimal agency risks that our owner (the government of New Zealand) will suddenly change our mandate. Our sovereign status is also beneficial in bringing the potential for us to be regarded favorably as stable sources of capital by business partners at home and abroad.

In the absence of sufficient information about the nature of the financial markets, there is substantial room to be swayed by fads and ideas that promise superior returns. Consequently, it is essential to distinguish between these and genuine investment insight, and this begins by articulating a well-founded investment philosophy, or set of investment beliefs. These beliefs are framed not just by an investor's understanding of market characteristics but also by the introspection required to identify their own strengths and weaknesses. As my colleague David Iverson writes in *Strategic Risk Management: A Practical Guide to Portfolio Risk Management* (Wiley, November 2013), "Investors without strong investment beliefs tend to drift from one strategy to the next. . . . Investors with clear investment beliefs tend to be more consistent and disciplined in their investment strategies and are more likely to achieve their investment objectives."

The Guardians have put in substantial effort at identifying our core investment beliefs, and our investment-decision process is fundamentally linked to these. The shared beliefs give us the confidence to choose specific investment strategies. The anchoring of our investment strategies to our endowments and beliefs enables us to stay true to our stated investment course, often when it feels the most unnatural. For example, it was exactly this anchoring that allowed us to negotiate the depths of the global financial crisis with a sense of opportunity rather than dread by retaining the focus on the important questions: Have our beliefs changed? Are our strategies correct? Do we have the capability to manage day-to-day financial operations in an unprecedented credit environment?

Our endowments and our long-term investment strategies that rest on clearly articulated beliefs can be made irrelevant if either the investment process or execution that follows is shoddy. How do we ensure consistency and discipline in our investment decisions, and how do we justify our choices? How do we balance the desired continuity and institutional perspective with dynamic, clever people?

Transparency is fundamental to the Guardians of New Zealand Superannuation; even the cupcakes must be accounted for.

In resolving these questions, we have decided on a benchmark investment strategy founded on a low-cost, passive, readily implementable global portfolio expected to achieve the fund's objective. This reference portfolio is chosen by the board and embodies its view of the risks that are appropriate for the Guardians as a long-term investor. For whatever other investment strategies we may choose, the reference portfolio allows all to gauge whether our activities add value. Separately, the single reference-portfolio construct also supports our cultural ambitions of working together as one team pursuing our collective goal.

Responsible investors must have concern for environmental, social, and governance factors because they are material to long-term returns.

For the active investment decisions we make, we have established a risk-allocation process that allows us to rank opportunities by financial attractiveness (expected returns adjusted for risk and our confidence) and consistency with our endowments, beliefs, target operating capabilities, and responsible-investment commitments. In short, we periodically identify and quantify the sources of risk and return in all active opportunities, including those already mandated using consistent methods and inputs. This allows us to clearly understand the additional risks each investment brings to our benchmark-reference portfolio, the return we expect to compensate for those risks, and the initial signal to allocate capital to and from investments on a timely, consistent, and commercial basis.

Finally, I note another element of our governance framework, sometimes overlooked by others, that relates to responsible investment. We believe that responsible investors must have concern for environmental, social, and governance factors because they are material to long-term returns. Our view is that constructive engagement is both good for returns and the advancement of our objective to be active owners and responsible investors. We also acknowledge the wider beneficial impact on corporate practice, regulatory standards, and the general functioning of capital markets from active, constructive engagement.

Good investments will come and go, and views on good investment strategies will change only slightly less often. However, it is a good governance framework that will primarily give the Guardians the discipline, courage, and consistency to stay the course and achieve our mission of reducing the tax burdens on future New Zealanders. Having been granted a "license to operate" on the basis of this framework, we owe it to our sponsors and all New Zealanders to be transparent and accountable for the choices we make—right down to cupcakes taken home. ■

[1] My comments in this section summarize the more detailed views in Sue Brake and Rishab Sethi, "The advantages of being a long-term investor," Guardians of New Zealand Superannuation "How We Invest" white paper, September 2014, nzsuperfund.co.nz.

[2] Of course, increased choice is only beneficial when these choices can help improve portfolio risk-adjusted returns. See Joe Cheung, "Diversification," Guardians of New Zealand Superannuation "How We Invest" white paper, September 2014, nzsuperfund.co.nz.

[3] These benefits are conditional on a degree of mispricing in the opportunities and the evidence for this is more uncertain than for the other advantages described.

John D. Rogers

Capitalism in The Postfinancial Era

Tempered by crisis, global in outlook, and focused on a time horizon measured in decades, the fiduciary capitalist is poised to take center stage.

It is very likely that the global financial crisis of 2007–08 will have been the single most disruptive event in the careers of investors alive today. Many of us have family members who lived through the Great Depression of the 1930s. That generation carries memories of bank failures and financial-market distress that have profoundly influenced its own investment and savings choices. A large number of people who came of age during the Great Depression emerged from the experience with a profound mistrust of financial institutions. The trauma of those times energized policy initiatives and labor unions' support of government social security and defined-benefit pension plans to provide workers and voters an economic safety net not found in the financial system.

It remains to be seen how the global financial crisis will affect the generation that just lived through it. Although financial markets have largely returned to pre-crisis levels, the trauma is likely to haunt us for decades to come. Already, we can see at least one important change: the era of "financialization" that lasted from about 1980 until 2007 is over, and a different set of economic drivers is taking its place. The "financial capitalism" of that span of years should be viewed as an anomaly. The historical role of

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finance is to enable economic progress. The era of financialization to some extent turned this on its head, and finance became viewed as an end unto itself, rather than as a means to an end. My belief is that the global financial crisis served as the catalyst to usher the finance sector back to its historical role as an enabling function.

The great opportunity for those in the financial community today is to support this type of healthy redirection by focusing on the long term. We live in an age when the environmental consequences of economic and human activity threaten the sustainability of life as we know it. Short-term thinking, which has contributed to these threats, is also the bane of corporate executives, policy makers, and the people who must live with the consequences of opportunism. Fortunately, there are some emerging themes within the investment community that may help counteract destructive short-termism. These forces, which I will group under the term "fiduciary capitalism,"[1] are outlined in the next few pages.[2]

The global financial crisis served as the catalyst to usher the finance sector back to its historical role as an enabling function.

In a fiduciary-capitalist economy, leadership in the deployment of capital comes from institutional investors with a long-term orientation. These institutions and their staffs are in virtually every case fiduciaries: bound to a duty of care and loyalty and obliged to place the needs of their beneficiaries above all other considerations. The main players in this group are pension funds, endowments, foundations, and sovereign-wealth funds. These institutions have an agenda that supports long-term thinking. The larger of these institutions have become "universal owners," bound to the overall outcomes of the global economy over many decades to come. As such, they are virtually obliged to engage with companies' management teams and public-policy makers on governance and strategy. Using the language of economists, they seek to minimize negative externalities and reward positive ones.[3] These investors are generally too large to engage in short-term investment strategies, and it is in their interest to minimize costs, which in the aggregate are a drag on returns to their beneficiaries.

FIDUCIARY CAPITALISM IN HISTORICAL CONTEXT

From the standpoint of economic drivers, I believe there have been three major economic eras over the past 60 years. First was the period from 1945 to 1980 that is often termed industrial or managerial capitalism.[4] Within leading free-market post–World War II economies, the corporate issuer of debt and equity was the dominant force in capital formation. A great deal of this occurred through bank loans, and corporate-governance problems were minimized through either dispersed ownership (the United States) or cross-holdings (Germany and Japan). Many remember this era for the rise of conglomerates and "national champions," which were nurtured with export-oriented market-share strategies. An analog to this in many of the socialist nations of the time would be state capitalism, where national wealth was channeled through government financial institutions and directly to government-owned entities.

Then, in the early 1980s, a 30-year decline in interest rates began. At the same time, financial markets in the West were deregulated, financial engineering became a new area of specialization, and we witnessed the ascendance of what is often termed financial capitalism, or financialization.[5] The biggest winners in this era were global financial intermediaries—banks, asset managers, and brokerage firms—that benefited from deregulation, technology, globalization, and a lower cost of funds, which supported greater leverage on their balance sheets.

These salubrious developments allowed the financial sector to achieve well-above-average growth in revenues, earnings, and market capitalization. Employment in the sector boomed, and good jobs in finance became global passports to success. As a share of US GDP, financial services grew from 4.9 percent in 1980 to 8.3 percent in 2006.[6] During this era, the public's (and many industry participants') perception of finance changed. Its existence began to be seen as an end itself, rather than as an enabling function.[7] This golden era for financial services ended badly in 2008 with the onset of the global financial crisis. While it is difficult to untangle and pinpoint the causes of the crisis, the finance industry took the brunt of the blame. Researchers at the Federal Reserve Bank of Dallas have estimated that the global financial crisis cost the US economy between $6 trillion and $14 trillion, or $50,000 to $120,000 for every US household.[8] Not surprisingly, the public today overwhelmingly mistrusts financial institutions. Deleveraging is now part of global financial institutions' agenda, and regulatory and prudential oversight of financial institutions is part of most governmental agendas.

FIDUCIARIES AS GLOBAL LEADERS

Out of this difficult period, leadership in finance and the economy could come from fiduciary capitalists. There are three megatrends supporting the idea that institutional investors could lead such an era of longer-term thinking. These include their size,

The collapse of Lehman Brothers in 2008 brought the global financial crisis to a head. The trauma of that crisis will haunt investors for decades to come.

the leveling power of technology, and their shared agendas:

- **Size.** Fiduciary institutions have grown to be among the world's largest investors. Even when agents (investment-management companies and other for-profit entities) are excluded, the top 1,000 such fiduciaries worldwide account for $25 trillion, or close to half the value of the world's equity markets.[9] These investors, either acting alone or in concert, command the attention of corporations and policy makers.
- **Technology.** Technology has leveled the playing field in finance. For decades, brokers and investment bankers enjoyed an asymmetric information advantage over their institutional clients. Today, that information gap is mostly gone. The digital age has put as much computing power and market access into the hands of large fiduciaries as in the hands of brokers and bankers. Sophisticated asset owners are moving their business away from traditional capital marketplaces.

Beneficiaries 50 or 100 years from now will inherit not only the profits but also the positive and negative externalities of investments made today.

Institutions are doing business directly with one another and as equal counterparts to sell-side firms.[10] Indexing, exchange-traded funds, and the availability of derivatives in almost any flavor have rendered much of the world's capital markets in the category of commodity products. With this, many institutional investors have chosen to "insource" the management of large portions of their asset pools. These investors are focused on low costs and a high degree of control. In Singapore, the $100 billion GIC, formerly known as the Government of Singapore Investment Corporation, employs more than 500 investment professionals, rivaling any asset-management firm or sell-side research department in sophistication. Institutional investors are powerfully redefining how markets operate.

Shared agendas. The third driver of this new era is found in the shared agendas of these fiduciary capitalists. Their agendas can be summarized as follows: maximize total returns to deliver real (inflation-adjusted) current and future income over very long time horizons. Where their agendas differ is essentially in that each of these institutions has a unique liability profile to consider. In turn, fiduciary capitalists' needs are not always aligned with what agents (banks and brokerage firms or for-profit asset managers) are accustomed to offering. To many fiduciaries, "alpha" versus a market benchmark, trading opportunities, short-term forecasts, and competition with peers is not particularly important. What really matters to these investors is a strategy that delivers the returns that are expected by their ultimate beneficiaries. In some cases, these returns are not purely economic. Social and environmental outcomes may be part of the mission of these investors, particularly in the case of foundations and sovereign-wealth funds. Moreover, many asset owners, for example, endowments, are "permanent" with regard to their expected lives. Their boards have come to realize that beneficiaries 50 or 100 years from now will inherit not only the profits but also the positive and negative externalities of the investments made by the fund today.

When we combine size, skill, and these agenda points, it is easy to understand that a number of large fiduciary investors are in the position of essentially owning all the outcomes of the world's corporate activity, far into the future. They have become "universal owners." As such, they have no choice but to become engaged in corporate governance and public-policy issues. The universal-owner label describes this reality, which is reluctantly accepted by some fiduciary investors and embraced by others.[11] An era of fiduciary capitalism begins when the majority of these organizations begin to act on their inherent advantages and responsibilities: a long-term investment horizon, the ability to change corporate behavior through effective engagement, and a comprehensive approach to accounting for costs, benefits, and investment results.

THE ROAD TO FIDUCIARY CAPITALISM

A number of things need to happen for the transition to fiduciary capitalism to occur. There needs to be more empirical evidence that "good governance" leads to higher performance over long time periods. Such evidence, which has begun to accumulate, will lead to an explosion of products and investment strategies delivered by agents, oriented toward this source of alpha. Today's accounting standards do not sufficiently address negative externalities. Such recognition is difficult, and the financial statements need to be augmented with supplemental information. There are a number of firms that are offering research and ratings that provide such augmented analysis. The investment-management industry can seize the opportunity to create products and services that specifically address the agendas of fiduciary capitalists. Fiduciary capitalists themselves need to embrace the natural advantages they have by engaging with investee firms as long-term owners. Here, too, firms exist that can support this engagement where the end investor's resources may not suffice.

Corporate boards have become somewhat cynical about the intentions of many owners of their shares. Holding periods of corporate equity continue to drop, and many buyers act more like renters than owners. This creates an unhealthy tension, which serves neither the issuer nor the shareholder. As universal owners, large fiduciaries should come to recognize that they are bound by liquidity constraints and trading costs in a long-term investment. This in turn sets up an opportunity for effective engagement with the issuer's management and board and

Can Fiduciary Capitalists Be Trained?

Professional education and credentialing, in the form of degrees, certifications, and charters, are among the hottest growth industries in business. Universities and professional organizations are quick to respond to significant new trends in job markets. In a world of growing interest in environmental, social, and governance investing, it is clear that a new crop of university programs and nonprofit credentialing organizations will spring up to meet the demand.

This is already the case. The New School's Milano School of International Affairs and Urban Policy, in New York, offers a master of science in environmental policy and sustainability management, as well as a post-master's certificate in sustainability strategies. Southern New Hampshire University offers a degree even closer to the theme of fiduciary capitalism, with its MBA program in sustainability and environmental compliance. Certification programs are also on the rise. UCLA's extension program offers a sustainability certificate program, as do Harvard University's extension program and the MIT Sloan School of Management.

As important as these programs are in preparing the next generation, education and certifications alone will not be enough. The incentive systems that drive behavior must be realigned toward the values of fiduciary capitalism: long-term outcomes, accounting for externalities, and stakeholder focus. As investors redefine their objectives along these lines, the measurements of success will change, and, in turn, incentive systems can be reworked to reflect these values. In finance, the most powerful motivators tend to be dollars and cents, and it is fair to expect that educational and credentialing systems will adapt to changing needs quite quickly.

should be welcomed by businesses looking for more stability and consistency from their shareholders. Under fiduciary capitalism, these corporate-management teams should be held accountable for long-term performance and for the total impact, not simply the bottom line, of their firms' activities. This approach to the meaning of investment helps restore finance to its original and intended function as an enabler of economic and social progress.

Under fiduciary capitalism, these corporate-management teams should be held accountable for long-term performance and for the total impact, not simply the bottom line, of their firms' activities.

As leaders, large fiduciary investors have a higher bar to clear for transparency, governance standards, and organizational sophistication. Today, too many institutional investors are secretive and do not disclose enough about their activities. Their beneficial owners (including voters, in the case of sovereign funds) need more information to make reasonable judgments about their operations. This information should include total operational costs, investment strategy and activities, governance policies, and financial data. A change is needed in the framing of performance, away from comparing returns with market benchmarks and in favor of defining and comparing the organization's returns in relation to its liabilities.

An era of fiduciary capitalism could focus financial markets on long-term outcomes that better take into account positive and negative externalities. The type of fiduciary capitalists described above have an exceptional opportunity, as well as an obligation, to take leadership positions in this important work. At the same time, virtually any investor can become a fiduciary capitalist. The steps involved include thoughtfully choosing an investment policy and strategy that promotes good corporate governance and environmental and social outcomes and avoids short-term tactics. There are many commingled investment vehicles offered to retail investors that have environmental, social, and governance strategies based on the principles of fiduciary capitalism outlined above. ■

[1] James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*, first edition, Philadelphia, PA: University of Pennsylvania Press, 2000.
[2] For more on this argument and to access the longer article upon which this piece is based, see John D. Rogers, "A new era of fiduciary capitalism? Let's hope so," *Financial Analysts Journal*, 2014, Volume 70, Number 3, pp. 6–12.
[3] Hawley and Williams, *The Rise of Fiduciary Capitalism*.
[4] Alfred D. Chandler, Jr., *Scale and Scope: The Dynamics of Industrial Capitalism*, first edition, Cambridge, MA: Belknap Press, 1990.
[5] Larry Neal, *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason*, first edition, Cambridge, United Kingdom: Cambridge University Press, 1990.
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[7] John C. Bogle, "Black Monday and black swans," *Financial Analysts Journal*, 2008, Volume 64, Number 2, pp. 30–40.
[8] Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How bad was it? The costs and consequences of the 2007–09 financial crisis," Federal Reserve Bank of Dallas, Staff Papers, Number 20, July 2013, dallasfed.org.
[9] Liam Kennedy, "Top 1000 Pension Funds: The thrifty thousands," *Investment & Pensions Europe*, September 2013, ipe.com.
[10] Scott Patterson, *Dark Pools: The Rise of the Machine Traders and the Rigging of the US Stock Market*, first edition, New York, NY: Crown Business, 2012.
[11] Roger Urwin, "Pension funds as universal owners: Opportunity beckons and leadership calls," *Pension Funds, Governance and Compensation*, 2011, Volume 4, Number 1, pp. 26–33.

Lim Chow Kiat

GIC's Long-Term View

For Singapore's sovereign-wealth fund, taking the long view is fundamental.

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In Singapore, long-termism is our national ethos. A willingness to forgo short-term gratification and keep faith with the fundamentals has served us well. It has been at the heart of our mission since the beginning of GIC, which was created out of a need to manage the precious savings that were set aside from limited financial resources in the early years of Singapore. As Dr. Goh Keng Swee, the former deputy chairman who conceived the idea of GIC, put it then, "There is no real secret about the way in which most nations and individuals grow rich. They must save a good part of their income, wisely and profitably invested. The more you save and the more wisely you invest, the faster you get rich."

GIC was set up in 1981 to benefit from that perspective. Specifically, GIC's mission is to invest for the long term so as to generate a good return over and above global inflation. Three decades later, GIC's performance has indeed benefited from a long-term perspective. Our investment return gained substantially from the compounding of returns, the patient harvesting of long-term risk premiums, the countercyclical rebalancing of our portfolio, the ability to take advantage of short-term dislocations in financial markets, and our long-standing relationships with many investees, external fund managers, and other partners. Enduring the short-term uncertainty, and occasional short-term pain, has paid off.

Over the years, we have learned that it is actually not the time horizon that matters most, but rather the mind-set and discipline to consistently invest based on fundamentals. In particular, it is important to have the ability to assess value and maintain price discipline in the face of market fluctuations and uncertainty. Having a long time horizon enhances this ability, especially in a world full of short-term investors. Professional investors like to bank on skill rather than luck. At GIC, we add long-termism to our formula.

In theory, long-termism should give investors a big edge. The reality, however, is that even investors with explicit long-term mandates find it hard to put long-termism into practice. In our experience, the organization's entire "ecosystem" must have a long-term mind-set for it to work. Both investment and organizational practices need to be supportive. From clients to employees, from front office to back office, and from internal investors to external managers, we try to ensure that long-termism permeates our practices. We break the necessary discipline down into five areas: the investment philosophy, governance framework, investment mandate, organizational practices, and communication.

1. INVESTMENT PHILOSOPHY

At the heart of GIC's investment philosophy is our value discipline. We look for the compounding of fundamental value and opportunities in price-value divergence. Both require a long-term orientation. We are also mindful that long-term investing does not oblige us to buy and hold for long periods. The holding period depends more on price and value than time. At the same time, while we obviously prefer market prices to move up quickly to reflect our assessed valuations, we are prepared to wait longer for the convergence than most investors.

> The reality, however, is that even investors with explicit long-term mandates find it hard to put long-termism into practice.

Translating this philosophy into practice requires constant, concerted effort. We start with an articulation of our investment principles, which we vigorously promote through multiple channels and constantly assess to make sure they drive our decision processes.

In our experience, it is more difficult to do this in the area of liquid markets. Real-time market prices, while useful for some purposes, can severely interfere with the long-term investor's discipline. The emotional Mr. Market, as master investor Benjamin Graham referred to the gyrating stock market, visits constantly to challenge that long-term philosophy. He tempts you to sell a profitable investment with a quick (but often small) gain and pressures you to sell a losing investment, even when the long-term prospects are good (and indeed may have become better because of the lower price). Short-term price swings, rather than careful judgment on fundamentals, could end up dictating investment actions.

Even more insidious, knowing that Mr. Market is always available as a way to quickly and easily exit an investment can tempt you to relax the necessary due diligence. The false comfort of a liquid market may weaken the rigor required. It is therefore critical to create an investment process that forces you to stick to a value discipline, which includes assessment rigor, a target buy list, premortem analysis, rebalancing, and monitoring of portfolio turnover, among other measures. Having the mind-set to look beyond marked-to-market prices and instead at fundamental developments in the assets has proved useful for this purpose. In equities, for example, it is critical to look beyond stock prices to actual business performance. When done well, this is a source of competitive advantage, given how rarely investors take such a disciplined approach. In recent years, we have also extended the advantage into the area of providing bespoke capital for investees. Our long-term and flexible capital has added to our opportunity set.

One of the most difficult investment decisions to make is one that forces you to stand apart from the crowd. In fact, the largest investment losses tend to arise from procyclical decisions. "Marked to peers" can be a powerful (and damaging) psychological driver of such flawed decision making. As the veteran investor Howard Marks puts it, "looking wrong" can destroy careers in most organizations. Yet the ability to make those difficult decisions is an important part of successful investing. That is why a clear articulation of a value discipline and long-term orientation is so important.

2. GOVERNANCE FRAMEWORK

A willingness to wait for the fundamentals to eventually play out does not mean there is no need for checks and balances. Assuring stakeholders that our portfolio is managed according to our mandate is essential. We have a "no surprises" policy, which means we are proactive in raising issues relating to risks and future challenges as a way of building and maintaining the confidence of our clients and board of directors.

Our governance design also addresses potential agency problems through clear approval authority, regular reporting, and separation of conflicting roles. At the board level, there are several committees to oversee such critical areas as investment strategies, risks, active management, audit, and HR practices. To ensure that we keep an eye on the really long horizon, we also have an advisory board that examines trends that span multiple decades, for example, new technologies and demographics.

In addition to avoiding conflicts of interest and ensuring that we look out for long-term developments, we pay particular attention to equipping various levels of authority with the necessary resources. This is particularly important as GIC's operations become more complex, requiring a greater in-depth understanding of issues. Hence, for a number of years, we have benefited from the services of several experienced investment practitioners who have shared their insights and networks in a variety of areas. For example, they gave us many useful ideas when we were working on a new investment framework two years ago. They also serve as experts in different domains and countries, rendering valuable help when we need additional assessment.

To keep an eye on the really long horizon, we examine trends that span multiple decades, for example, new technologies and demographics.

3. INVESTMENT MANDATE

Whether it is our client's mandate to us or our mandate to external managers, we look for clarity. Clear statements on the return objective, risk capacity, and scope of authority give fund managers the confidence to construct the best portfolios for delivering sustainable results. In particular, the appropriate time horizon for evaluation should be discussed and agreed on up front.

GIC manages Singapore's reserves on behalf of the government. The government's investment mandate to GIC is to preserve and enhance the international purchasing power of the funds over the long term. That directive is set out clearly in an investment-management agreement with GIC.

At the aggregate-portfolio level, the 20-year-rolling real rate of return—that is, the return above global inflation—is the key investment metric for GIC. Within the aggregate portfolio, we have a policy portfolio comprising several asset classes and an active portfolio made up of several active strategies. Each portfolio and strategy, at every level, has a clear set of objectives, including a return objective, risk capacity, and scope of authority. The minimum time horizon for performance measurement is five years. In addition, we work hard to prepare expectations for potential return paths. This is to avoid surprises and allow our investors to act in a long-term manner.

We would like to adopt the same approach with more of our external fund managers, including granting longer-term lockups in return for better performance and more favorable terms. Unfortunately, we are often hampered by the fact that most other investors do not have a similar time horizon. Their need and desire to have redemption liquidity make it difficult for us to structure long-term mandates. This is an area where long-term asset owners could work together. In some cases, the reluctance of external fund managers to provide ongoing process visibility also poses a problem, as long lockups require us to validate performance regularly.

When two investors produce the same outcome, it tells us little about who has done a better job. We ask what role process and luck played.

4. ORGANIZATIONAL PRACTICES

As in any organization, the culture at GIC emanates from the top. Senior management takes every opportunity to advocate the importance of a long-term approach. Besides regular public articulations of this, we demonstrate resolve through our decisions in human-resource practices, resource allocation, and other business areas. We want to ensure that there can be no doubt about our seriousness regarding these issues.

We emphasize long-termism in career development. In hiring, we consider mindset fit and career runway; in development, we provide opportunities for exposure to different parts of the business, and we increase responsibilities to extend the career runway; in exiting, we do extensive succession preparation and work to expand our alumni community. Our human-resource practices focus on making GIC one of the best places in the world to practice long-term investing.

It sounds like simple common sense to say that successful long-term investors must be evaluated and rewarded based on their long-term performance. Although it is obvious, it is sometimes harder to implement than you might think. First, long-term investors are often in competition with other employers that offer short-term incentives. While we believe that our total value proposition is superior, we must be careful not to stray too far from the typical employment package. This partly explains our practice of using multiple time periods to measure performance. Doing so also helps to ensure that process goals or interim targets are also met and reduces the likelihood of someone becoming too passive after a difficult start.

In addition, effective performance-evaluation and reward systems must go beyond an extended evaluation horizon. Several other elements are necessary.

Differentiating process from outcome, especially for interim results. When two investors produce the same outcome, it tells us little about who has done a better job. We ask what role process and luck played in the outcome. We also ask how much risk, and what sort of risk, was incurred. We believe you can only control the process; the outcome is simply a consequence of that process.

Evaluating performance at the total portfolio level rather than at the component level. There is often great temptation to focus on selective results. While that is useful for understanding the whys and hows, the overall result is more important.

Our incentive scheme closely follows the output of the evaluation. If the evaluation is done well, the incentive will be right.

5. COMMUNICATION

There are two aspects to highlight in this area. First, communication is important to surviving the long and often bumpy ride. Long-term investors not only need to get the investment call right but also need to maintain stakeholder confidence that the investment strategy will most likely turn out right, even if current market prices indicate otherwise. At GIC, we try to make sure that the next-highest level in our organization understands the risks and challenges involved before embarking on an activity.

Second, we are conscious that nomenclature is destiny. The right word engenders the right attitude and the right behavior. From how a report is presented to how an investment loss is explained and how a concept is described, we are meticulous about word choice, as well as how we deliver the message. For example, we avoid displaying only short-term performance results, especially at important forums. This is to prevent the perception that we emphasize short-term results. We avoid using a phrase such as "consistent results" so that our teams do not wrongly focus on quick bets and quarterly gains. We prefer to say "sustainable results." We find that a nice saying such as

> We are conscious that nomenclature is destiny. The wrong words can corrode, if not corrupt, our process.

"the long-term is but a series of short-terms" is extremely harmful. In our view, it is not true—at least not for investing. We would correct someone in our organization if he or she used that phrase or one like it. The drivers of short-term investment outcomes and the drivers of long-term investment outcomes are very different. In most cases, the former have to do with market emotions, while the latter have to do with fundamental developments such as competitiveness. Think of Benjamin Graham's "voting" and "weighing" machines. The wrong words can corrode, if not corrupt, our process.

Long-termism and a value orientation are at the heart of all we do, but to put these principles into practice requires constant vigilance and discipline. The entire ecosystem must share the same orientation, especially in the areas of investment philosophy, governance framework, investment mandate, organizational practices, and communication. If we get those things right, however, we believe we will be rewarded with achieving the investment goals we have set for ourselves. ■

Getting Beyond The Data Point

In the age of ubiquitous information, long-term thinking provides a structural advantage to fund managers—and helps them contribute greater value to society.

In the predigital age, asset managers had an information advantage. They tended to find out things first. They just knew things that other people didn't know. That advantage is gone. Today, more information—much more—is available in general, and it is available to everyone, professionals and amateurs alike, simultaneously. Access to data is no longer a differentiator. Today, if you are an asset manager, your advantage needs to be how you process the data. And part of that is to take a longer-term view.

When you take a longer-term view, you're not so much looking at data points. You're looking at trends. You're looking at the shape of the information, rather than the information itself. That's a different perspective, and one where you can actually start to see the patterns and make sense of the individual data points. You're looking for data that confirms or undermines your long-term ideas. It can provide a structural advantage by giving you a view of risk that other people might not see. I'm thinking of environmental, social, and governance risks, as well as other big disruptive and systemic risks. In addition, by taking a longer view, you can find the interactions and correlations among investment positions that others might not be conscious

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of because they haven't looked at the larger shape of the information.

Once you learn to do that, a lot of things change. You no longer need to be reliant on quarterly reports. You do better analysis. You think about it longer. You don't even need as many investment ideas, because you can have the confidence to take bigger stakes and hold them longer. You become more engaged with the companies you invest in. And you can think more deeply about portfolio construction, stress testing the entire portfolio for possible events and performing better analysis on the long-term risks and opportunities of individual holdings.

But to be successful, you have to learn to look at risk in a whole new way. For one, environmental, social, and governance issues—all the things shorter-term players don't worry about—become critically important. If a company has suspect employment practices, such as using child labor in overseas factories or exploiting illegal immigrants, those practices could be bolstering profits in the short term, but in the longer term, they create an open-ended risk. This could manifest itself in a consumer boycott and or some other serious business disruption down the line.

A NEW VIEW OF RISK

Similarly, if a company is using financial sophistry to avoid paying taxes or if it has terrible environmental practices, it might be boosting performance in the short term but dramatically increasing risk in the long term. These are the sorts of issues that have the potential not just to torpedo a company's share price over a week or a month but also to destroy its business model. You only tend to worry about them, however, if you're thinking longer term. A high-frequency trader who is buying a stock for five minutes before turning it around will not give much thought to these kinds of potential catastrophes.

> A sensible long-term investor will tend to invest in companies that are better behaved simply because they're less risky.

An important benefit of long-term investing is that it leads to better-quality decisions, more risk-aware decisions. At a societal level, the more long-term thinking there is, the more funding will go to those companies that will generate wider social benefits. For example, if you imagine an investment choice between two resource companies, one that is operating to a high ethical standard and another that falls short of doing so, then for an equivalent level of profitability and profit growth, the second company has a lot more open-ended risk. A sensible long-term investor will tend to invest in companies that are better behaved simply because they're less risky.

A big problem is that most professional investors and managers have not been trained to look at data in this way. In both cases, education tends to be quantitative and numbers driven. For chartered financial analysts, there's a lot of emphasis on the accounts and quarterly results. The training teaches people to look at financial metrics and, on that basis, make investment decisions. They are not trained to look at the wider context and consider societal and governance risks. The training does not focus on the details and implications of the business strategy. Real businesses are run by real people who have their own needs, who can be greedy and abuse power or be selfless and devoted to the greater good of their organizations. The existence of an appropriate governance framework that avoids moral hazard should be a major consideration in investing.

This hugely important human element is

frequently underplayed. You have to understand the business plan of the companies you're considering investing in, but you also have to be able to judge the talent and character of the people you're relying on to execute that plan. Is the business model sustainable? Are the people in place capable of executing that plan? Those questions of human judgment tend not to get discussed as much in the formal training in my profession. Some of the best training in my career has come from people outside the industry—for instance, from lawyers, who have shown me how to ask questions that get to the truth, or from conductors, who have shown me how to get a collection of talented individuals to work together as a whole.

Investee companies could help the situation by providing a broader range of information. We've been early advocates of integrated reporting, which encourages companies to give us detailed information on environment, social, and governance issues in a narrative format so that we can make more informed decisions. If you are going to hold an investment for years, rather than weeks or months, you need to understand that broader context; a more complete narrative helps. We need less data and more rich discussion of the business. What is the company's overall ethos and business strategy? Where is it going?

We need less data and more rich discussion of the business. What is the company's overall ethos and business strategy? Where is it going?

We don't need to have those reports every quarter. Just report semiannually. We could cope with that. Once a company gets locked into that quarterly cycle, it leads to a series of bad outcomes. If you've trained your investors to watch the target number and then you miss it, they'll sell. If, on the other hand, you have shared your business vision with your investors, they would not and should not be supportive of management stopping a profitable investment, say, in a new subsidiary, simply to meet quarterly guidance.

Similarly, in the asset-management business, we've trained our clients to assess us by benchmarking performance every quarter or even every month. The reality is that whatever is measured is what gets managed to. Fund managers have strong incentives to try to beat their benchmarks, sometimes to the extent that they forget about the goals of the original asset owner.

Another factor driving short-termism in asset management is the noise that's created by the media. Ultimately, this is a commercial business. Interestingly, we don't make money, particularly, from great investment performance. Our clients do. We make money from the accumulation of assets. The more assets we manage, the more money we make. Usually, there's a connection between those two things, but it's not perfect. If you're seen as a successful fund manager, you will accumulate more assets, so the public image of whether you're good is really important. And if you look at how the media normally assesses fund managers, few outlets are considering ten years of performance history. Most of the time, the media tends to cover the person who was calling for the market to go up this year or the manager who was in the right stock this quarter. Generally, the things that get the most coverage are short-term phenomena.

Meanwhile, our clients have to act on the information they have. If they see my team underperforming for three quarters in a row, I can remind them that I have a long-term strategy and that this is just a short-term aberration, but that is probably not going to be enough. Unfortunately, there is a knowledge imbalance in the industry that is hard to overcome. Clients know a lot less about capital markets and our investment processes than we do, so they have to make their judgment on good fund managers versus bad fund managers using what they believe is the most objective information at hand. For many clients, that is the quarterly fund ranking. This is a powerful incentive for us to focus on short-term performance metrics.

BUILDING A BETTER PORTFOLIO

There is another way for fund managers to encourage a longer-term perspective, and that is to spend a lot of time focusing on portfolio construction. It's a way of investing for the long term while managing risk for the short term. What I mean by that is taking steps to make sure that your investment portfolios are not going to be blasted out of shape by one or two decisions going against you. In our case, we have built a portfolio with a two- or three-year investment view. But we stress test it to make sure that over any quarter, if any kind of big event happens, we have a sense of how the portfolio would perform. We consider possible extreme events such as all out war in the Middle East, banks melting down in Europe, or interest rates being raised in the United States—events that would stress the markets.

We assess how the portfolio would perform under those conditions and what we could do to mitigate potential volatility. For example, if you wanted to include in your portfolio an idea for an investment with great long-term potential, but it was exposed to rising interest rates, you would look across your inventory of other investment ideas for the industries or businesses that would benefit from interest rates going up. If interest rates were to rise, it would probably be broadly helpful for some of our insurance picks, and we could add one of those stocks to the portfolio. The hope is that the two ideas would both work in the long term but be complementary in the short term.

The goal is to address the risk of short-term volatility while keeping the portfolio invested

> Fund managers can encourage a longer-term perspective by focusing on portfolio construction. It's a way of investing for the long term while managing risk for the short term.

in long-term ideas. One important thing the asset-management industry needs to do to help itself is to elevate portfolio construction to the same level as idea generation. That just has not happened in our industry. It's been all about the idea generation—and often quite short-term idea generation.

There are many advantages of long-term thinking. They are usually discussed with respect to various stakeholders—shareholders, employees, suppliers, customers, local communities, and society at large. It is stating the obvious to conclude that these are all important. But I believe that learning to think longer term, to view the shape of the information rather than being blinded by data points, enables better investment decisions. It supports us in fulfilling the foundational role of asset managers, which is to ensure that capital finds its way to those investments that provide the greatest utility to the economy by delivering sustainable long-term returns. If we can do that, we will keep our clients happy, and we will be comfortable in our skin as valuable members of society. ■

Reporting for The 21st Century

Traditional company reports do a good job of tracking finances and tangible assets. That's not nearly enough for businesses today.

Doing business in an increasingly volatile, uncertain, complex, and ambiguous world poses profoundly different challenges from those of the past. Globalization, rapid innovation in technology, and demographic swings are driving a level of change that our business structures have not yet caught up with. Over the past 30 years, for example, there has been a fundamental shift in macroeconomic value to a point where more than 80 percent of the market value of companies now lies in intangible assets.[1] Yet many accounting practices and processes do not reflect this shift. This new set of circumstances urgently requires a change in behavior to focus more on long-term value creation. As Mervyn King and Leigh Roberts put it in their book *Integrate: Doing Business in the 21st Century* (Juta & Company, September 2013), "It's time for business as unusual."

In this article, I will set out my view of how integrated reporting, a new corporate-reporting initiative, can help companies address the information needs of both investors and business decision makers within this changed dynamic. With a focus on long-term business success and integrated thinking, integrated reporting helps organizations tell their story in their own words, addressing the specific concerns of long-term investors. In addition,

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integrated reporting can aid value creation by providing a framework for business decision makers to better understand material interrelationships among the elements of their business model in the context of the external business environment.

The integrated-reporting initiative is spearheaded by the International Integrated Reporting Council (IIRC). The IIRC's long-term vision is for integrated thinking to become standard business practice in both the public and private sectors, and integrated reporting to become the predominant mode for companies to use in reporting results to stakeholders.

An integrated report may be prepared either as a stand-alone report or be included as a distinguishable, prominent, and accessible part of another report or communication. It is essentially a narrative report, supported by traditional financial reports, that integrates all the factors material to an understanding of the value created by an organization and its future potential in a clear and concise manner.

Numerous national and international reporting regulations exist, and in the short term, integrated reporting is not going to replace these requirements. But in my opinion, there is no other framework that operates across the breadth of the activities within a business and its external context to the same extent as integrated reporting. It provides an umbrella framework under which other reporting requirements can be accommodated. For instance, the 2013 UK Strategic Report and Directors' Report is consistent with the principles underlying integrated reporting, the EU directive on disclosure of nonfinancial information recognizes that this legislation is moving toward integrated reporting, and integrated reporting is mandatory in South Africa.

The IIRC anticipates that, given time, organizations will stop producing numerous, disconnected, and static communications and replace these with an integrated report that would accomplish the following:

Integrated reporting can aid value creation by providing a framework for business decision makers to better understand material interrelationships among the elements of their business model.

- **Make the allocation** of capital more efficient and productive through improvements in the quality of information available to providers of financial capital.
- **Identify and communicate** the full range of financial and nonfinancial factors that materially affect the ability of an organization to create value over the short, medium, and long term.
- **Recognize the importance** of a broad range of capital (financial, manufactured, intellectual, human, social and relationship, and natural) to provide a thorough understanding of the organization's business model.
- **Support integrated thinking,** enabling business decision makers to focus on value creation over the long term.

I believe that integrated reporting is an initiative whose time has come, and this view is supported by the six largest global accounting networks. In a report[2] commissioned by the B-20, the business forum that advises G-20 governments, the networks endorsed integrated reporting as an important innovation that will make corporate reporting more conducive to long-term investment.

The linkage between integrated reporting and long-term investment has been demonstrated by George Serafeim at Harvard Business School.[3] He studied more than 1,000 US firms to find the correlation between the use of integrated reporting and the time horizon of the investor bases they attracted over the period 2002 to 2010. His research included not only those firms that prepared integrated reports but also those that reflected the principles of integrated reporting in their full range of published reports. Serafeim found that the greater the degree of integration included within firms' reporting the more long-term their investor bases were. More research will be needed on the impact of this longer-term investor base, but I contend that this research further supports the linkage between integrated reporting and a greater ability to focus capital on the long term.

In an article in the *Harvard Business Review*,[4] Dominic Barton and Mark Wiseman argue that investors have an obligation to end what they see as the plague of short-termism. They call for providers of capital to alter the lens through which they view investment to focus more capital on the long term. One of the practical changes they suggest is for these major asset owners to demand long-term metrics from companies as a step toward changing the investor-management conversation.

Research further supports the linkage between integrated reporting and a greater ability to focus capital on the long term.

I believe that there is also a complementary need for companies to focus their reporting on the long term. For instance, Novo Nordisk, the Denmark-based global healthcare company, has for a number of years published long-term targets. Its latest long-term targets include the usual profit, sales, margin, and cash metrics but also targets that, although not directly financial, support long-term financial performance. These fall into two groups: social targets, which include employee motivation and senior-management-team diversity; and environmental targets, which include energy and water use, emissions, and waste. Novo Nordisk's aim is to ensure long-term profitability by mitigating risks and minimizing negative impacts from business activities, and to enhance the positive contributions to society from the company's global operations.

Evidence from the IIRC's pilot program of more than 100 organizations using integrated reporting shows that the benefits are not restricted to improved relationships with long-term investors. There are also internal benefits. For example, because integrated reporting requires them to consider the various types of capital they deploy, many companies have reassessed the way they work across their business, as well as the way they use technology to integrate information and, ultimately, change the way they report results to reinforce the connectivity of information. In this way, organizations have strengthened and made more transparent the causal relationships that exist among strategy, the business model, and value creation.

Research[5] undertaken by the Chartered Institute of Management Accountants and Tomorrow's Company (a London-based international think tank) emphasizes the value of integrated reporting beyond its role as a reporting framework. First, it can help an organization to better understand and connect the disparate sources and drivers of long-term value to enable better strategy formulation and decision making. In addition, it provides a synthesis of how value is created, helping to win trust and secure reputation by encouraging better relationships with investors, employees, and other stakeholders.

A DEEPER UNDERSTANDING OF THE BUSINESS MODEL

Integrated reporting combines an emphasis on conciseness and future orientation with a strong focus on strategy, the business model, and value creation. Making the connectivity of information and the interdependencies of various forms of capital transparent enables a more efficient and productive allocation of capital, both among businesses and within businesses. Integrated reporting applies principles and concepts that are focused on bringing greater cohesion and efficiency to the reporting process, and promotes integrated thinking as a way of breaking down internal silos, reducing duplication, and driving positive behaviors for long-term success.

But what does it take to truly develop integrated thinking? I contend that it begins with a thorough understanding of the business model that lies at the heart of the organization's value-creation process. Such an understanding is essential for identifying both risks and opportunities. The International Integrated Reporting Framework defines an organization's business model as its *"system of transforming inputs, through its business activities, into outputs and outcomes that aim to fulfill the organization's strategic priorities and create value over the short, medium, and long term."*[6]

So what does the IIRC mean by inputs, business activities, outputs, and outcomes?

- **Inputs** are the resources, relationships, and other forms of capital that the organization depends upon or which provide a source of differentiation. Integrated reporting describes those inputs that are material to understanding the robustness of the business model.
- **Business activities** are what the organization does to create value for itself and its stakeholders (including society).
- **An integrated report** identifies an organization's key products and services as well as any by-products, waste, or emissions that require discussion, based on how material they are to an understanding of the robustness of the business model.
- **Actually producing something** or making a service available is not necessarily a long-term value-creating activity; what is crucial is the outcome that results. Do customers purchase the output? Do they make repeat purchases or recommendations to other potential customers? And does the output generate brand loyalty? Outcomes can be both internal (employee morale, revenue) and external (customer satisfaction, tax payments) as well as either positive or negative.

A thorough understanding of the business model that lies at the heart of the organization's value-creation process is essential for identifying both risks and opportunities.

It is this need to identify and describe outcomes, particularly external outcomes, that drives an organization to consider the kinds of capital it uses beyond just those that it owns or controls. And it is this broadening of the range of factors to be taken into account in business decision making that underlies integrated reporting and provides its more long-term foundation.

BUSINESS-MODEL ANALYSIS

The need to understand the business model exists at both the tactical and strategic levels within an organization. At the tactical level, the focus is on an almost forensic analysis of the mechanics of the business model. At the heart of this detailed analysis, which spans the organization, are the imperatives of improved customer experience, cost leadership, minimizing environmental impact, and the effect of competitor activity. In an era of increasing volatility and rapid change, the goal is to maximize long-term value creation by optimizing opportunities and minimizing value-limiting factors.

At the tactical level, the organization's business model needs to be viewed through a variety of lenses. These include cash flows, profit generation, dependence on external relationships, technological reliance, operational processes, and the impact on the organization's reputation and risk exposure.

These lenses should be focused on the long term. However, pressure persists on business leaders to deliver financial results in the short term. According to a survey commissioned by McKinsey and the Canada Pension Plan Investment Board,[7] out of more than 1,000 executives representing the full range of industries and company sizes, nearly 80 percent of respondents said that the time frame in which they felt the most pressure to deliver financial results was two years or less.

Nevertheless, the importance of reputation risk was shown by a recent global Chartered Global Management Accountant survey[8] of more than 1,300 finance leaders, conducted by the American Institute of Certified Public Accountants and the Chartered Institute of Management Accountants. More than three-quarters of those surveyed indicated that their company was prepared to lose profit in the short term for the sake of protecting long-term reputation, and the same number is putting more focus on reputational risk now than in previous years.

At the strategic level, the analysis is driven by the board's need to understand how their organization creates value through its chosen business model and the risks it faces. Airmic's 2011 study[9] of more than 20 major corporate failures identifies a number of cases in which the board's failure to understand the business model contributed to a major crisis. I believe that a thorough understanding of the business model must underpin the boardroom conversation, to help it determine if the activities of the organization are effectively aligned with the overall strategy; to help it identify risks; and to help focus discussions of strategy.

LOOKING TO THE FUTURE

I firmly believe that a thorough understanding of the business model supports better integrated thinking and decision making, leading to better governance, better performance management, and better reporting—what I'd call better business. However, I recognize that more work needs to be done to convince many boardrooms that integrated reporting, underpinned by integrated thinking, will help them run their businesses more successfully in the long term. The Chartered Institute of Management Accountants will seek to establish this case by asking the following questions:

- **What conversations** are boards currently having about the business model?
- **To what extent** is this supporting a longer-term perspective?
- **What are the challenges** in trying to understand and promote a common view of the business model?
- **What information** do organizations need to understand the business model?

Answering these questions will also help us to develop the tools and frameworks that companies need to run their businesses sustainably. I look forward to sharing the initial findings of this research in 2015. ■

[1] "Ocean Tomo announces 2010 results of annual study of intangible asset market value," April 4, 2011, prweb.com.
[2] *Unlocking investment in infrastructure: Is current accounting reporting a barrier?*, B-20 panel of six international accounting networks, June 2014, theiirc.org.
[3] George Serafeim, *Integrated Reporting and Investor Clientele*, Harvard Business School, 2014, hbs.edu.
[4] Dominic Barton and Mark Wiseman, "Focusing capital on the long term," *Harvard Business Review*, January–February 2014, pp. 44–52, hbr.org.
[5] *Tomorrow's Business Success*, Chartered Institute of Management Accountants and Tomorrow's Company, in association with the International Integrated Reporting Council, July 2014.
[6] *The International <IR> Framework*, International Integrated Reporting Council, December 2013, theiirc.org.
[7] "Short-termism: Insights from business leaders," survey commissioned by McKinsey & Company and the Canada Pension Plan Investment Board, January 2014, fclt.org.
[8] "Companies put reputation before profit, says global survey," Chartered Institute of Management Accountants, 2013, cimaglobal.com.
[9] *Roads to Ruin: A study of major risk events: Their origins, impact, and implications*, Cass Business School, City University London, and Airmic, 2011, airmic.com.

A Framework for Integrated Reporting

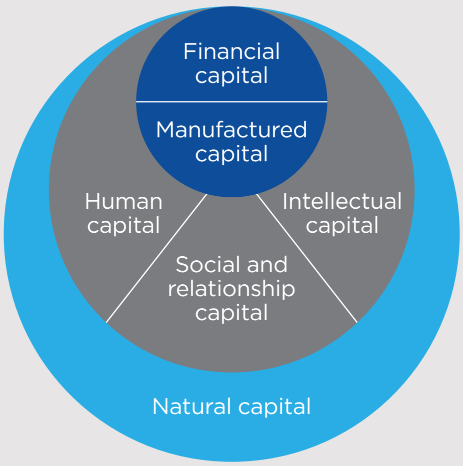
To facilitate the adoption of integrated-reporting principles, the International Integrated Reporting Council (IIRC) launched its formal framework in December 2013.[1] It presents steps for making sure the integrated report provides insight into the resources and relationships that are used and affected by an organization, referred to as "the capitals" by the IIRC (exhibit).

The capitals are stocks of value that are increased, decreased, or transformed by the organization's business activities. The extent to which the organization can capture value for itself governs the financial returns to the providers of financial capital. However, the organization should also be viewed through the lens of other stakeholders and society at large. The nonfinancial elements of the capitals, including manufactured, intellectual, human, social and relationship, and natural, which are nonetheless material to an organization's ability to create value for itself, should also be reported in an integrated report.

Following its recent pilot program with 140 leading businesses, institutional investors, and public-sector organizations including Gold Fields, Microsoft, National Australia Bank, Natura, PepsiCo, and The Crown Estate, the IIRC has announced a number of specific steps aimed at increasing adoption of integrated reporting, as well as a separate technology initiative.

Financial capital: the pool of funds available to an organization

Manufactured capital: manmade physical objects, such as buildings, equipment, and infrastructure



Intellectual capital: knowledge-based intangibles, such as intellectual property, knowledge, systems, and procedures

Human capital: the competencies, capabilities, and experience of employees, such as motivation to innovate, alignment with governance framework, understanding of strategy, and loyalty

Social and relationship capital: the relationships within and among communities, groups of stakeholders, and other networks and their common values, including brand and reputational intangibles

Natural capital: all renewable and nonrenewable environmental resources and processes such as air, water, land, minerals, biodiversity, and ecosystem health

[1] "*The International <IR> Framework* released with business and investor support," International Integrated Reporting Council, December 2013, theiirc.org.

A Single Ladle from A Flowing Stream

Long-term investing requires patience and discipline from all players in the ecosystem.

Lei Zhang is the founder and CEO of Hillhouse Capital Management Group. Hillhouse manages approximately $16 billion for endowments, foundations, sovereign-wealth funds, and family offices. Zhang is the vice chairman of the board at Renmin University of China and serves on several councils at Yale University. He earned a BA from Renmin University and an MA and MBA from Yale.

A few years ago, I was invited to be a speaker at a conference for the Chinese investment-management community. The Chinese markets, like emerging markets all over the world, are volatile. So, the thought goes, the best way to make money is to trade frequently, lest you end up holding the short straw. The conference organizers knew that my firm, Hillhouse Capital, had both very low turnover and excellent performance. They were surprised to see these two things exist in tandem. My speech was billed as, "How to make money despite being a long-term investor."

Other Chinese investors often tell me they would like to be long term too, but they can't afford to because of their fiduciary duty to make money for clients. I sympathize with this sentiment because there is some truth in it. Great long-term investments are simple in theory but difficult in execution because they will undoubtedly test your patience and resolve, especially in the face of potentially steep interim losses. Another necessary condition for the successful execution of a long-term strategy is the backing of investment partners who remain patient and resolute alongside you. Fund managers who are forced to continually make money or defend short-term results can never truly take a long-term outlook.

A FOCUS ON ENTREPRENEURS

Having partners who are long term themselves gives me freedom to focus on what I love, which is working with exceptional entrepreneurs to build businesses that optimize for the next ten years rather than the next quarter. The founders of Blue Moon, Luo Qiuping and Pan Dong, exemplify this idea. We first met Blue Moon in 2006. At the time, Blue Moon was a leader in liquid hand soap. The company was able to grow organically and was not looking for investors. We were intrigued by the entrepreneurs and kept in touch, often sharing our research on the global household/personal-care industry. In 2008, the company had a small R&D breakthrough with a new type of liquid clothing detergent. At the time, multinationals had a big presence in China in the powder-detergent market. Liquid detergents were a premium product and the Chinese were thought to be too cost-conscious for this concept.

We believed Blue Moon had a window of opportunity to seize the liquid-detergent market in China. Globally, this market stood at nearly $20 billion, and it seemed inevitable to us that the rise of the Chinese consumer would add to this number. As a result of these discussions, Blue Moon decided to go full steam into liquid detergents, spending heavily on marketing, distribution, and manufacturing build-out. The Blue Moon founders turned a small enterprise that made steady, handsome profits into a loss-making enterprise with the potential to become a multi-billion-dollar powerhouse. Hillhouse was an enthusiastic participant in this decision and became one of Blue Moon's only significant external shareholders, investing in 2010. The company became an early pioneer in China in creating products synonymous with quality, a strategy that has allowed it to become not only the largest player in the liquid-detergent segment but also to build a brand that is considered more premium than multinational counterparts like Tide.

Many entrepreneurs in our portfolio share similar stories. Tencent intentionally under-monetized its early social network, QQ, for many years in order to focus on consumer experience. Hengan, one of China's biggest consumer companies, emphasized a slower-growing feminine-products business line over a fast-growing tissue-paper division because tissue brands are less defendable over time. In its start-up years, Baidu cut its only money-making division, the SMS-advertising business, in order to focus solely on search.

> In China, most entrepreneurs suffer from the problem of having too much choice rather than too little.

One of Hillhouse's guiding principles is a phrase borrowed from the 18th-century Chinese classic novel, *Dream of the Red Chamber*. The phrase translates roughly into, "Out of a flowing stream, I need only a single ladle of water." In China, most entrepreneurs suffer from the problem of having too much choice rather than too little. They are surrounded by innumerable "opportunities" that offer the promise of a quick buck. The willingness of the exceptional entrepreneurs to focus and delay gratification in the wholehearted, almost ascetic pursuit of a greater long-term mission is what inspires me to keep investing.

This principle applies to Hillhouse as well. Investing in equity, the residual value of a business, over the course of several years or decades forces decision making in the face of strategic ambiguity and requires a specific mind-set. A few years ago, one of my analysts came to me with a structured-finance deal that would have generated a 25 to 30 percent internal rate of return within a few months. I turned it down. I didn't want my organization to spend time on marginal ideas that distract from the challenging work of honing long-term judgment, no matter how attractive these opportunities might sound.

The intersection of great ideas and exceptional people is, by definition, rare. When we find great entrepreneurs, we do all that we can to help them build their companies. This is not completely altruistic. For one thing, helping a company define strategic direction reduces our investment risk. Second, helping our existing entrepreneurs extend their franchise value by reaching new markets and deepening competitive moats means we can stay invested for much longer. We are lucky to have three or four new investment ideas a year, so reducing or eliminating the need to "change horses" drives compounded returns over the long term.

We have the conviction to pursue our own ideas and are not beholden to the "spot market" of available deals or companies.

For example, we've worked on a number of initiatives over the years with Tencent, our very first portfolio company. We introduced Tencent to MNC, Indonesia's largest media conglomerate (with whom we have been invested for many years). Together, the three of us formed a joint venture in Indonesia to grow Tencent's mobile-chat service, WeChat, in Indonesia. We helped form a strategic partnership between Tencent and JD.com, China's largest B2C retailer. As part of this partnership, Tencent merged its e-commerce assets into JD.com, and JD.com will be able to leverage Tencent's social-network data and capabilities to provide better service and products to its customers. Some people believe that investing is a zero-sum game, that you can only win if someone else loses. I think long-term investing is positive sum, that everyone in the game benefits.

Hillhouse is an active participant in strategic decisions, but we are never activists. We would never try to force a decision on a company. We're never hostile. If we are ever in a situation in which we are completely at odds with the entrepreneur, then we have probably made a bad judgment. We certainly have had our fair share of mistakes and battle scars. In these situations, we walk away and take our losses. Life is short and we want to spend quality time with quality people.

KNOWLEDGE AS A STRATEGIC ASSET

We are in many ways like a university, focused on the pursuit of truth through research. When a team member has a good idea, he or she can spend months, even years, learning as much as possible about the business, sector, or geography without the pressure of finding a commercial application. We once looked at the evolution of retail over the past hundred years across both Western and Asian markets to understand why certain retail formats were stronger in some markets than others. As a result of these sorts of multiyear efforts, we have the conviction to pursue our own ideas and are not beholden to the "spot market" of available deals or companies.

This perspective would be difficult if our research activities were geared toward trying to meet a deadline for a deal, or trying to understand volatility when it hits. If our research leads to an attractive investment or helps us incubate a new business, then great. If not, we are happy to wait until the right time comes. Maybe there will never be a right time, and that is OK; we encourage research simply to indulge our curiosity and get closer to the truth.

Long-term-oriented research allows you to have conviction when others don't, and partnering with like-minded limited partners gives you the freedom to act on this conviction. This is why we are stage agnostic and invest in everything from private growth companies to public companies. We invest in companies that have minimal or no earnings, or in companies that go from positive earnings to negative earnings with our advice and encouragement. We hold on to companies without pressure to sell and help them compound in value. We invest not only in China, but across Asia and the rest of the world and put capital to work wherever we find exceptional entrepreneurs.

Our clients allow us the flexibility to call capital during market depressions and return capital when we feel there are not enough opportunities to deploy it.

For example, during the depths of the financial crisis, I got extremely excited by the valuations of our existing portfolio companies. I called my clients and said I wanted to double down on the fantastic businesses we owned, which we thought were fundamentally sound but priced like they were going to fail. Shortly after Lehman Brothers collapsed, Hillhouse took in one of the largest capital inflows in its young history.

Hillhouse has performed well by any measure over the past ten years, but this has not precluded us from having periods of underperformance. We can hold onto (or buy more of) companies with strong long-term fundamentals and poor-performing stock prices because our investors understand what we are doing and give us the leeway to execute. We don't ask our entrepreneurs about quarterly earnings; this sort of information is not relevant to what we do or what our limited partners are interested in.

Long-term investing cannot exist in a vacuum; it needs an ecosystem for support.

Long-term investing cannot exist in a vacuum; it needs an ecosystem for support. Even though the short-term-trading mentality of the Chinese market has provided us with some interesting buying opportunities, it is ultimately a risk to the entire system. Entrepreneurs cannot reach their full potential without staunch support from investors, and investors like us cannot provide that support without the backing of our clients.

In China, I have organized a group of equity investors to share thoughts about fundamental investing. I support start-up fund managers who share Hillhouse's long-term philosophy and help them get their businesses off the ground. People think this is pretty strange; even a few of my own team have questions about why I am so eager to develop potential competitors. I see it as expanding the entire long-term ecosystem and enlarging the pie for everyone. I deeply believe that long-term investing is a positive-sum game. I also have a soft spot for all true entrepreneurs, and the investing business, especially in a market as dynamic as China's, is certainly one that calls for plenty of entrepreneurial spirit and determination.

Who you are depends on who is around you. Hillhouse's fundamental reason for existence is to help quality people build quality companies, and we must do all that we can to work with our partners to create an ecosystem to support this mission. ■

Building a Business-Owner Mind-Set

It's time to start investing based on long-term fundamentals rather than short-term volatility.

Michael Sabia is the president and CEO of Caisse de dépôt et placement du Québec, which manages public and private pension funds in Québec. Previously, he was chief executive of BCE, Canada's largest telecommunications company. Sabia earned a BA from the University of Toronto and an MPhil from Yale University.

By definition, long-term investors have a stake in the long-term health of the economy. Measured over years and decades, their performance is tied to the innovation, productivity, and growth of the companies in which they invest and, more broadly, to economic prosperity as it grows over time. These investors have good reason to focus on the business fundamentals of the companies and projects they invest in, on important policy choices, and on the broader fundamentals of the economy itself. In a word, long-term investors need to be builders.

Short-term investors have a different frame of mind. Fundamentally, they are traders. Their business depends on the hourly, weekly, or quarterly price swings of a stock, which can be completely disconnected from the underlying condition of companies or the state of the economy. Profit can be generated in good or bad times, based on the short-term movements of interchangeable stocks.

In today's financial system, the problem is that too many—far too many—investors have become traders who treat companies like commodities. But companies are not commodities. They play critical roles in allocating resources, determining levels of investment, fostering innovation, creating jobs, and contributing to productivity and prosperity. When we treat companies as commodities—that is, when we trade them rather than invest in them—we run the risk of undermining the long-term growth prospects of our economy.

Why? Because as traders press for short-term performance, CEOs have no choice but to focus their strategies on quarterly performance, to the detriment of long-term investment plans that might be costly in the near term but often enhance growth potential. Spread across the breadth of our economy, this dynamic contributes to the sort of slow growth we are experiencing globally today.

Many share this concern. In fact, the importance of investing with a long-term perspective is now much discussed, as the Focusing Capital on the Long Term initiative demonstrates. The beginnings of a consensus for change seem to be taking shape.

This being said, the truth is that long-term investing is difficult. Especially today, when information circles the planet in minutes, the pressure for short-term results has never been greater, and financial intermediaries have become omnipresent, increasing complexity, risk, and costs.

These are significant headwinds. To navigate such an environment successfully, long-term investors require independent governance, a renewed focus on culture and process, sound risk management, and, of course, the right people. Above all, they must return to the roots of asset ownership: investing in the real economy with a business-owner mind-set.

INVESTING LIKE AN OWNER

What does it mean to invest with a business-owner mind-set? What are the distinctive traits of business owners? What distinguishes them from traders?

> In today's financial system, the problem is that too many—far too many—investors have become traders who treat companies like commodities.

The first part of the answer is knowledge—deep knowledge. Business owners are not satisfied with secondhand reports or periodic reviews of P&L statements; they know and understand the fundamentals of the company or asset they invest in. They are intimately familiar with its culture, people, operations, and strengths and weaknesses. They understand the industry and know the competition. And they have a deep sense–impervious to short-term market fluctuations or flights of fancy–of their business's intrinsic value.

This expertise is not passive or detached: business owners engage with management. They exercise their judgment and make considered decisions based on rigorous analysis. They have a clear idea of where their business is heading.

Finally, business owners display loyalty to their company, but not at any cost. In return, they expect performance and work hard, with management, to achieve it. They are independent minded. While they are aware of what others may think, they are ready to look beyond it. They are prepared to make tough decisions and work through difficult times.

Of course, all this serves as a metaphor. Institutional investors are not business owners, and they should not actually start running companies. That said, we do believe the business-owner *mind-set* is a useful inspiration for the successful pursuit of long-term investing.

INSTILLING THE MIND-SET

For 50 years, Caisse de dépôt et placement du Québec (la Caisse) has been managing public-pension and insurance funds.

We have more than CAD 215 billion (USD 189 billion) in assets under management, more than 90 percent of which is managed internally. Coming out of the 2008–09 crisis, la Caisse began working to instill a business-owner mind-set throughout the organization. Here's how that mind-set plays out across various asset classes.

Real Estate

At la Caisse, we do not simply invest in real estate: we own and operate it. With more than CAD 40 billion in assets, our Ivanhoé Cambridge subsidiary has become one of the leading operators of real estate in the world, with 1,700 employees and properties in Asia, Europe, Latin America, and North America.

When making investment decisions, Ivanhoé Cambridge is not focused on how to dispose of acquired properties in a three- to five-year horizon or on the financial engineering underlying the transaction. Instead, it analyzes the tenant base, potential long-term disruptions, and opportunities for operational improvements to the property's management.

Fundamental research is a better way to manage risk than a simple reliance on technical tools, tracking of benchmark deviation, or the wisdom of crowds.

Developing such a deep understanding of assets—including at the operational level—presents a number of advantages. It provides a rigorous and independent sense of the value and potential of an asset, which increases resilience in the face of turmoil. Fundamental research is also, we believe, a better way to manage risk than a simple reliance on technical tools, tracking of benchmark deviation, or the wisdom of crowds. Deep knowledge is a prerequisite for investors willing to take more concentrated positions instead of the usual practice of hedging their bets and diversifying across the investment landscape.

This focus on deep knowledge has become a cornerstone of our investment approach.

Infrastructure

Infrastructure is a natural asset class for the long-term investor. Typically illiquid, long term in nature, and resistant to easy benchmarking, infrastructure-investment decisions must rely on a rigorous understanding of intrinsic value and risk.

As with our real-estate portfolio, applying a business-owner mind-set to our infrastructure investments requires us to answer a number of questions: Is the project economically important and, hence, is it viable for the long term? Do we understand it well? Is the expertise available to manage it through good times and bad? What operational improvements can we make? La Caisse aims to provide unambiguous and durable responses to these questions, as we normally approach infrastructure acquisitions with little or no consideration for the date of resale.

Public Markets

We have also decided to expand the business-owner mind-set to our public-markets team. This represented a radical departure from the status quo.

In 2013, we launched a high-quality global equities portfolio built on the core principles outlined earlier. The portfolio is worth CAD 25 billion, concentrated in about 70 companies, with an annual turnover rate of about 10 percent. Stocks are selected on the basis of proprietary fundamental research, which also serves as an essential risk-management tool.

Crucially, it is a *benchmark-agnostic* portfolio: while its performance is measured against an index over a long horizon, it is not built around a benchmark and is not expected to track one. This is a near-complete reversal of our previous strategy. Adopting a business-owner mind-set has meant letting go of indexes.

We are now in the process of expanding this approach to other major equities portfolio. By the end of 2015, CAD 50 billion of assets will have been shifted away from our previous, benchmark-driven strategy to one that, we are convinced, will deliver far more durable results.

Even though equity portfolios don't always allow for the same kind of engagement as real estate or infrastructure, we've tried to import the same overarching principles: deep research, a focus on intrinsic value as opposed to benchmarks, fundamental risk assessment, and resilience in the pursuit of long-term objectives.

Private Equity

The business-owner mind-set also appears ideally suited to private-equity investments. Importing the principles outlined above to la Caisse's current and future private-equity operations represents the next frontier in our plan.

Once again, the point is not to operate companies directly. Instead, we will be striving, along with our partners, to be an active (but not activist) investor, not bound to any specific benchmark, seeking only to invest in businesses we believe in. These may be companies that are performing well but are underpriced, or they may be companies in which we see opportunities for sustainable performance improvement.

La Caisse is developing this level of engagement and ownership one transaction at a time—occasionally taking board seats, making recommendations, and using our influence—as we learn from past successes and failures.

THE ELEMENTS OF A LONG-TERM CULTURE

All institutions hoping to keep their focus on the long term face challenges. Public markets in particular are awash with distractions. While no one is completely immune to the anxieties of market volatility, holding steadfast to a few principles and practices may help to navigate turbulent seas.

Independent Governance

Investors hoping to remain committed to their principles must be able to withstand pressure from government, other institutions, and public opinion.

In practice, this requires three things: truly independent governance, shielded from interference from political actors and outside interests; an ability to resist public criticism or impatient calls for a change in direction; and freedom to set compensation policies adapted to the marketplace. A number of guidelines exist to achieve these objectives, and they should be adopted, in letter and spirit, by all investors serious about making and maintaining their own decisions.

Talent

For any institution, the first priority is finding individuals who understand its philosophy and values and who are willing and able to further them. Compensation structure and processes help to align individual incentives with institutional objectives but cannot serve as a magical cure for fundamental differences of perspective.

For la Caisse, the combination of a business-owner mind-set and a focus on long-term risk assessment has meant hiring people with broad horizons, diverse backgrounds, operational experience, and a willingness to engage with the management of portfolio companies. Our search for experienced business operators has often led us far beyond the traditional recruitment pool of the financial industry. We have hired engineers, geologists, and executives with operating experience in mining, consumer products, and IT, among many other areas. We want people who have a clear understanding of how value is created in a sector—because we believe durable value is created through excellent operations, not financial engineering.

Culture and Process

What is an organization's culture? In our minds, ultimately, it is how work gets done. It is the fabric that brings together the individual skills of our people. Building a culture that resists the temptation to follow the crowd and seek immediate results has been one of our toughest challenges. We still have a long way to go.

We are trying to build an institutional culture that values the kind of knowledge, independence, and patience that lead to deep convictions. That means striving to understand companies and assets as deeply as a business owner, truly engaging with the companies we invest in, and weighing fundamental, long-term risks.

Building a culture that resists the temptation to follow the crowd and seek immediate results has been one of our toughest challenges.

When making investment decisions, we place a great deal of emphasis on the pooling of knowledge across the organization to marshal our best insights. This has meant breaking down the silos that have historically separated one asset class from another and investing in information-management systems that facilitate collaboration.

This deliberate pooling of knowledge has been an important ingredient in our move to a more collective approach to investment decision making. Our new process relies on the value of debate as the best way to get the real issues on the table. For example, we don't have an investment committee. We have an investment-risk committee. The distinction is important because it implies that in a discussion of any investment proposal, we expect a debate between our investment and risk teams. We regard this as a key part of developing the deep convictions we need to take large positions and hold them for the longer term.

With that same goal in mind, we are also trying to adopt a more strategic approach to investment decision making. Every year, we ask each asset-class team to develop and present to our board a four-year plan that identifies its investment priorities and where it intends to take its "business" over the coming period. Throughout the year, individual investment decisions are evaluated against those four-year priorities.

Compensation

Indispensable to our strategy is an ability to pay our investment professionals on a commercially competitive basis. Without it, we would not have access to the talent we need. That being said, *how* we pay our people is as important as *how much*. Four years ago, we put in place a new compensation program built on a number of principles that aim to support our long-term business-owner mind-set:

- We offer pay for performance over a four-year rolling period.
- Individual, team, and la Caisse–wide performance counts for everyone.
- Risk management is everyone's responsibility.
- We try to make investment decisions as if we were investing our own money—to that end, as an example, our senior executives are required to invest more than half of their annual bonus in la Caisse's portfolio.

Risk

Equally important is a robust assessment of risk. Should we be concerned about fluctuations in asset value, deviations from a benchmark, or permanent loss of capital? Should we focus on financial factors, broader determinants of risk, or both?

La Caisse has adopted a pragmatic approach: risk is assessed from a number of perspectives, each providing its own insights. But our priorities have shifted.

We are now mainly concerned about deep risk and permanent loss of capital, and we give extensive consideration to both financial and nonfinancial risk factors. Like business judgment, risk management is both an art and a science. To that end, we are working to pool expertise and encourage open (and at times vigorous) debate.

While we continue to track volatility using all available tools, la Caisse no longer sees this measure as the be all and end all of risk management. Our focus is firmly placed on deep research and stress testing the performance of both individual assets and our overall portfolio. We are gradually moving away from certain tools, like VaR, that often obscure more than they reveal.

To put it simply: the criteria that figure into an evaluation of risk over a 30-day window are of limited relevance to a 30-year investment horizon. When thinking about value over multiple years or decades, near-term fluctuations fade in importance next to core strengths and weaknesses, fundamental movements in demography and technology, and the stability of economic and political systems.

When thinking about value over multiple years or decades, near-term fluctuations fade in importance next to core strengths and weaknesses.

Why is all this important? Beyond catchphrases and good intentions, is there fundamental value in long-term investing with a business-owner mind-set?

We deeply believe so.

Long-term investing creates a virtuous circle that improves risk-adjusted returns over time. It encourages corporations to adopt longer-term objectives, invest in innovation, and focus on building superior longer-term performance. At scale, it can stabilize and improve capital markets. And it helps to reduce the noise and distractions that often lead markets to irrational turbulence. In a fast-paced world, taking a step back makes sense.

As large, global investors, our ability to meet our clients' long-term expectations depends on markets that ultimately reward responsible and creative decisions.

We believe all institutions that have the ability to break free from the tyranny of short-termism should consider the broadly shared benefits of investing for the long term. If we all chase the market based on one another's movements, we are really all just chasing our tails. Surely, we can do better than that. ■

The Long-Term Imperative for Financial Institutions

Finding innovative solutions to the challenges of the future will require stable capital markets and intermediaries.

James P. Gorman is chairman and CEO of Morgan Stanley. He joined the firm in 2006 as president and COO of global wealth management, and was then copresident and cohead of corporate strategy. He previously held a succession of executive positions at Merrill Lynch, was a senior partner of McKinsey & Company, and an attorney in Melbourne, Australia. Gorman earned a BA and law degree from the University of Melbourne and an MBA from Columbia University.

The strengths of well-functioning global capital markets include speed, scale, and efficiency in capital mobilization and allocation—attributes that, while positive, sometimes foster short-termism. Mobility and interconnectedness increase the speed of transacting and communicating but render it easier for decision makers to be caught in the welter of immediate concerns. Now, more than ever, corporate and financial leaders must clearly focus on the longer term in their strategic planning and investment decisions.

The following facts illustrate why this reorientation is vital: In 1950, the world's population was 2.5 billion; today, it exceeds 7 billion, and by 2050 it will have grown to more than 9 billion.[1] Much of this change will occur in major cities already grappling with issues created by dense population and high growth rates. Rapid urbanization, scarcity of clean water, inadequate nutrition, lack of housing, and periodic disease outbreak not only multiply the challenges to providing basic life necessities, they also affect economic growth and social prosperity.

These trends will alter the complexion of our economies and societies. To provide a prosperous, sustainable world for a larger population, we must develop markets less prone to structural upheaval and more capable of funding projects and companies that provide widespread, sustainable benefits and operate with respect for the planet. This means thinking today about how to plan for, manage, and adapt to tomorrow's realities, and requires a resilient financial infrastructure prepared to thrive under new conditions.

Many consider issues like climate change, poverty, and global health to be largely the purview of governments, philanthropies, and nonprofits. Each of those sectors no doubt plays a critical role in setting policy, providing essential services, and supporting innovative approaches to address market failures. The private sector, however, has a crucial role to play by deploying innovative technologies and developing new business models to meet changing social and economic circumstances. Companies that focus on these challenges will be best positioned for long-term growth; indeed, attempts to quantify the value of sustainable business opportunities yield estimates ranging from $3 trillion to $10 trillion annually by 2050, potentially 4.5 percent of the world's projected gross domestic product.[2] By harnessing the speed, scale, and efficiency of global capital markets, private sector-led solutions can proliferate and present the best chance of addressing challenges ahead. This concept is central to financial services.

For centuries, the prudent allocation and deployment of capital has been essential for economic growth and development. In the early 19th century, railroad and steel entrepreneurs built entire industries with the support of finance. In the century since, the development of deep, liquid public securities markets accelerated and democratized capital formation, enabling fresh business models that drove new industries. More recently,

By harnessing the speed, scale, and efficiency of global capital markets, private sector-led solutions can proliferate.

telecommunication pioneers and Internet visionaries have accessed markets to build companies that change how members of societies communicate, learn, and interact. The prospective challenge we now face is to channel capital to the innovators who will turn ideas into companies addressing our greatest social concerns, while also providing attractive risk-adjusted returns to capital providers. Private capital must be a part of building a sustainable world; in fact, without such capital, sustainability is unsustainable.

Morgan Stanley is committed to building a long-term sustainable economy that yields social benefit. As a global financial institution, this means we must do several things.

First, we must ensure that we have a sustainable business model that is not only resilient but also contributes to a sound global financial system. This is a central tenet for any leader of a financial institution. Living up to this tenet demands a sound business, in all regards, from capital reserves to risk-management procedures, corporate culture, and a commitment to our communities and environment.

Within financial services, the past five years have been a journey; they have required difficult decisions to manage increasingly complex regulatory and operating environments. Thankfully, significant progress has been made in establishing institutional strength and stability. For example, at Morgan Stanley, liquidity at the time of the crisis was approximately $81 billion against an aggregate balance sheet of $1.2 trillion; it is now $190 billion against a balance sheet of $815 billion. Our leverage was 30 times and is now 12, while our capital has grown from $35 billion to $73 billion.[3] These were necessary changes.

The pre-crisis Morgan Stanley was a high-velocity, volatile collection of businesses that had fewer checks and balances. Today, the firm has become a deliberate, de-risked, balanced, and integrated enterprise focused on client advisory and execution rather than proprietary activity. We invested in businesses like wealth management, which provide ballast and predictability, while maintaining a leading investment bank and institutional securities franchise that offer first-class service to our clients. These measures, coupled with the actions taken by our regulators and industry peers, contribute to the improved resilience and soundness of the financial system.

Second, we must integrate a long-term perspective in evaluating investment opportunities for our firm and partner with clients that do the same. Information may cause markets to move rapidly, but prudent stewards of capital should also recognize long-term trends and their cumulative effects. We increasingly consider factors such as natural-resource scarcity and climate change in our daily processes of evaluation and review. Far from being just an exercise in risk mitigation, this represents a significant growth opportunity for those companies that successfully anticipate the products, strategies, and services that the future will demand.

For these reasons, we established the Morgan Stanley Institute for Sustainable Investing. Its mandate is to maximize capital's impact in supporting a more sustainable future by building scalable financial solutions that seek to deliver competitive financial returns, while promoting positive environmental and social impact. Through product innovation, thought leadership, and capacity-building programs that expand opportunities for sustainable investing, the Institute furthers capital's role in achieving sustainable economic growth.

Many of our clients actively think about sustainability as a key business driver as well. For example, when we help a company like Tesla with its initial public offering, the implications extend far beyond the immediate capital raised.[4] Tesla generated excitement among car enthusiasts by creating a fully electric vehicle with high performance standards and sleek design. Fueled by critical policy decisions, technological advances, and customer choice, a robust electric vehicle market can be financially rewarding while contributing to reducing carbon emissions and illustrating how to pair attractive, risk-adjusted returns with positive social and environmental outcomes.[5]

Similarly, the rapidly growing market for green bonds (which finance environmentally sustainable projects) demonstrates how financial-services firms can partner with clients to allocate capital resources to long-term instruments. In 2014, green bond issuance exceeded $30 billion, up from just $1 billion a few years ago.[6] Unilever, for example, partnered with our firm to issue its first-ever green bond last year; proceeds will help to reduce greenhouse-gas emissions, improve water usage and waste output, and increase energy efficiency at new and existing facilities. In the municipal sector, we supported the Commonwealth of Massachusetts in issuing the largest tax-exempt green bond, capital that will finance green infrastructure projects across the state. These are fundamental and laudable changes in clients' approach to finance.

Our individual clients also are eager to make long-term sustainability a central part of their portfolios. In fact, sustainable, responsible and impact investing assets now account for more than one out of every six dollars under professional management in the United States. In the last two years, US-based assets under these strategies have grown 76 percent, exceeding $6.5 trillion in assets under management.[7] To accommodate this demand, we launched our Investing with Impact platform, offering more than 120 vehicles that enable clients to align their values with their investments. Products focus on a variety of objectives, including clean energy, pure water resources, and affordable housing. To date, our clients have invested more than $4 billion through the platform, and we aim to channel $10 billion to it over the next few years. Interest will grow with the coming generational wealth transfer: younger generations, poised to inherit some $40 trillion of wealth,[8] are likely to seek products that pair economic returns with social and environmental benefits on a much larger scale.

Third, we must invest our time, talent, and resources to advance sustainable growth and prosperity for all. Institutions like Morgan Stanley can contribute meaningfully to sustainability by investing our time, talent, and resources. For example, we are collaborating with partners to provide economic opportunities to people with low and moderate incomes. Since 2010, we have invested more than $7 billion in high-impact programs such as equitable transit-oriented development and the Healthy Futures Fund, innovative programs that connect people in affordable housing with work and co-locate healthcare facilities near their homes. Such efforts create cohesive, vibrant communities that are the basis for economic well-being.

In addition, our Institute for Sustainable Investing helps develop the next generation of long-term-oriented business leaders. In partnership with INSEAD and the Kellogg School of Management at Northwestern University, we recently challenged teams of graduate students from around the world to demonstrate how investing can go hand-in-hand with positive social impact. Teams from 39 universities in ten countries responded with remarkable innovation and enthusiasm. The winning idea proposed transitioning ecologically damaged land to poplar forests that would decontaminate the soil and could be sold for commercial use. These efforts illustrate that combining human capital with global perspective and reach produces results that are tangible, effective, and attractive to all constituents.

The course of history has proven that rigorous analysis, underpinned by thoughtfulness, determination, and collaboration, can solve seemingly intractable problems. The social and environmental challenges posed by population growth and resource scarcity are significant and accelerating. Financial services will play a particularly vital role in providing the capital necessary for the private sector to generate creative and rewarding solutions to these problems. For these reasons, acting as a catalyst for sustainability is critical to our strategy and we stand with our clients, communities, and peers in our commitment to it. ■

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GOVERNING

Governance And Stewardship For the Long Term

Boards and asset owners should focus on issues that can make a sustainable difference.

David Walker is chairman of Barclays. Previously, he served as chairman and CEO of Morgan Stanley International. Walker began his career with the British Treasury and served on secondment with the International Monetary Fund in Washington, DC. He was also one of four executive directors of the Bank of England and chairman of the Securities and Investments Board. Walker helped lead the independent review of the report produced by the Financial Services Authority on the failure of Royal Bank of Scotland in 2011.

The need for leadership in the boardroom is even greater now than during the depths of the financial crisis. In a crisis, the board and executive are concerned with survival, where there may be few if any alternatives to firm and immediate corrective action. When a crisis phase passes, the need is then to set a sustainable long-term strategy, which, since it is likely to involve complex choices, is more intellectually challenging.

In this context, the transition to a long-term mind-set is critically important. Without more focus on long-term strategy and long-term thinking, the model of market-based capitalism, which has served Western economies so well, is at risk of being undermined. Already we can see other forms of ownership, such as family- or private-equity-owned businesses as well as state-owned enterprises, becoming more significant in global economic activity. In the United States, where the number of publicly traded companies has fallen from about 8,000 to about 5,000 since 1999, there's been a material delisting from public markets.

TIME TO REFOCUS BOARDS

Boards face several important barriers to long-term thinking. Perhaps most important is the increased regulatory burden, necessary attention to which can take up a large part of the entire board agenda. Additionally, boards do not always have the information and authoritative risk analysis they need to provide the necessary challenge to a proposed strategy. Even when in a position to make well-considered decisions on a new strategy, a board may be held back by uncertainty as to the degree of shareholder support. Then there are relatively new issues, in particular the need for the board to find the critical balance between keeping up with the rapid development of new technologies and drawing on experience and judgment in business decisions that may involve substantial disruption.

I do not have the answers to how boards might best meet these challenges. It would, in any event, be a mistake to generalize: board situations differ greatly. Instead, I will try to focus the discussion by raising four questions that boards should pose to themselves.

1. Are you spending enough time and effort assessing the organization's long-term strategy?

If boards are honest, the answer will frequently be "no." There is little mystery about why that is. The time constraint is plainly serious and, acknowledging this, some observers have proposed the formation of a board-level strategy committee to which the main board can delegate. I am not in favor of that as a general proposition. Strategy is a fundamental responsibility of the board and should engage the whole board without delegation.

Apart from the inevitable timing constraints, the quality of the board's discussion and decision making on strategy will depend on a combination of the capability of individual board members, some of whom should have expertise in the business, and the way in

Strategy is a fundamental responsibility of the board and should engage the whole board without delegation.

which the process is conducted. To the extent possible, the board should be put in a position to review options, which they should be encouraged and indeed expected to challenge. It is often advantageous for the board to take several bites of the cherry before being asked to make a firm decision on a preferred strategy as articulated by the executive.

2. Do you have a clear understanding of the risks the organization faces?

In this case, I do advocate a separate board-level committee and indeed, since the financial crisis, most major banks, insurance companies, and other financial-service entities now have a financial-risk committee that complements the audit committee. There is, in my view, a need for clear differentiation between the traditional role of the audit committee, which is essentially backward looking, and the role of the risk committee, which looks ahead.

Given that the core product of any financial institution involves some form of financial risk, the need for a board-level financial-risk committee is compelling in any major financial institution. But other major nonfinancial entities face business-specific risks of their own, and governance involving a dedicated board-level risk committee is increasingly being seen—and embedded—as good governance practice.

But beyond this, even a traditional risk committee may not be enough. In a major financial business, the financial-risk committee deals with "hard" risks such as credit, counterparty, market, and liquidity risk. But it may not deal as adequately with "soft" risks such as conduct, reputation, and other behaviors, which, though hard to measure, can be greatly problematic when they go wrong.

One major ingredient in board-level appraisal of risk is the possibility of disruption from new technologies, which can be a serious challenge if not adequately addressed but also a great opportunity. For some businesses, new technology is so critically embedded in core products that one or more executive board members are continually engaged with the issue. In other cases, the board may be provided with input from outside. Whatever the approach, the critical nature of technology in virtually all of modern business means that both the board's overview of current operations and its strategy discussions should be supported by the best possible technology advice. It is thus a major responsibility of the chairman and CEO to ensure this.

Confidence in shareholder support should be a major priority for a board in developing a long-term strategy.

3. Is the board interacting with the CEO and executive team in the most productive way?

In my view it is the role of the chief executive in any business to present proposals to the board at the beginning of the strategy process, wholly distinct and separate from any preoccupation with short-term earnings performance. It is then the board's job to review and test the proposals with whatever degree of challenge is necessary, and then for the board to fully empower the CEO to implement the agreed-on strategy. In this way the CEO is, appropriately and necessarily, at the beginning and end of the strategy process.

This should not, however, preclude the board from seeking independent external input on a strategic issue when it wants to have greater confidence that the strategic decision it has made is a sound one. Some CEOs may see the board's seeking external input as an unwelcome challenge. But the purpose, which should be common to both executive and nonexecutive board members, is to increase the ability of the board to make the best possible strategic decision. Readiness to seek such independent external advice where appropriate is indeed part of the responsibility of the board, to promote the company's performance in the best interests of the shareholders.

4. Do you have the support of your shareholders?

Awareness of and confidence in shareholder support should be a major priority for a board in developing a long-term strategy for the business.

It is the role of the board, usually through the chairman or chief executive, or both, to communicate with shareholders in order to promote confidence in the ability of the board to develop and implement a credible long-term strategy.

How this is accomplished will depend on the particular characteristics of the organization. These include the share ownership structure, the objectives of major shareholders, and the level of effective communication between owners (the shareholders) and their agent (the board) in ways that do not breach market confidentiality obligations. However this is done, it will be extremely important for the board to actively seek and obtain as much assurance as possible that, despite an understandable degree of preoccupation by some people with short-term earnings, at least a core group of the company's shareholders are supportive of the board in its determination to decide on and implement a sustainable long-term strategy.

THE ROLE OF STEWARDSHIP: Fund Managers and Asset Owners

A large share of investable assets is managed by third-party fund managers. Thus, most board-level communication with the investor community is necessarily with fund managers, who have a clear fiduciary responsibility to the asset owners (the source of their mandates). This means that the ability of the fund manager to promote effective stewardship of the strategy of an investee company depends on the guidance and direction set in the investment mandate from the asset owner. In this situation there is opportunity and need for asset owners, in particular those with long-term horizons, to ensure that the mandates that they give to third-party fund managers articulate their objectives and requirements as fully as possible. These mandates include clear guidance on the time horizons on which fund-manager performance will be assessed, and, where possible, could be complemented by an explicit preference for support of the boards and management of investee companies in ways that offer exceptional returns over a longer period.

Given the key role of the fund-management community in creating the right atmosphere for a focus on long-term performance, one possibility would be to institute an annual survey of CEOs or chairmen in which they anonymously grade fund managers. The performance on which they would be invited to focus would not be the returns generated for the asset owner but rather the fund managers' accessibility, how they communicate, and their ability to react and, where appropriate, offer advice within appropriate constraints of confidentiality.

Asset owners need to ensure that the mandates they give to third-party fund managers articulate their objectives and requirements as fully as possible.

WORKING TOGETHER FOR THE LONG TERM

The high rate of inflation and associated high interest rates of the 1980s could be used to justify a board-level focus on projects offering quick payback. But while those conditions are now in the past, other factors leading to a greater focus on quarterly earnings, as well as the immediacy of performance measurement made possible by technology, are a continuing if not increasing distraction from a focus on the long term. The means to control this are at hand, but implementation requires new determination from boards and a visible stewardship role for asset owners and fund managers. The prize for success will not just be better and more sustainable returns for investors but also benefits in output and income generation for society as a whole. ■

Minding The Gaps

Why we need to encourage long-term investment

Angel Gurría has been the secretary-general of the Organisation for Economic Co-operation and Development (OECD) since 2006. He has worked to reinforce the OECD's role as a hub for global dialogue and debate on economic-policy issues. Previously, Gurría served as secretary of foreign affairs and secretary of finance in Mexico.

The largest economic crisis of our lifetimes is now in its sixth year and the costs are heavy. In spite of recent improvements, most of the countries in the Organisation for Economic Co-operation and Development (OECD) are still experiencing low economic growth, high unemployment, growing economic inequality, and eroding trust in institutions. The engines of growth are only slowly recovering, while those in emerging economies are decelerating. If we look ahead, the short- and long-term perspectives are sobering. In 2014 and 2015, growth in OECD countries is expected to average 2.2 percent and 2.8 percent, respectively.[1] Even in the long term, we foresee a coming era of slower growth. According to a recent OECD study, aging populations in many OECD countries and a gradual slowing of high growth rates in the large emerging economies will trim increases in global GDP from an annual average of 3.6 percent in the 2010–20 period to an estimated 2.4 percent in 2050–60.[2]

This perspective, along with the urgent need to create more and better jobs, has brought investment policy back to center stage. In fact, investment policy has become one of government's most precious tools for getting beyond the crisis as well as for building more resilient economies and more inclusive societies. Governments need to address an array of immediate and sometimes urgent challenges, but at the same time they have the opportunity, and to a certain extent the responsibility, to build the foundations of a new era of sustained, inclusive, and sustainable growth. In this context, the design and implementation of policies to promote long-term investment stands out as one of the central issues in public policy.

What are the main challenges that long-term investment policy should target? What are the most effective ways to bring about these needed long-term investments? These are some of the important questions that I intend to address in this article.

BIG STRUCTURAL CHALLENGES: Short-Term Impact, Long-Term Vision

Our countries are facing myriad structural challenges. The way we resolve these challenges will have a great impact on the kind of world that we will leave to the next generations. At the OECD, we are dealing with many of these challenges, promoting the exchange of visions and policy experiences to find the most effective ways to address difficult and complex issues. While the list is long, there are at least four structural challenges that demand a long-term strategy and that could therefore benefit significantly from long-term investment decisions.

The Peril of High Unemployment

First, we need to address the most serious social ill facing our member countries, and indeed countries around the world: the prevalence of high unemployment, particularly youth and structural unemployment. There are still close to 45 million people out of work in the OECD, 10.3 million more than in 2008; in certain countries, youth unemployment has surpassed 50 percent.[3] The numbers, however, do not capture the full picture. Long-term unemployment brings elevated risks of poverty, ill health, and school failure for the children of affected workers. Some youth are opting out of the labor force altogether, ceasing to look for work.

The challenge now is not simply to get more people into paid jobs but also to create more meaningful employment, increase female participation in the labor force, and enable more and better opportunities for people to earn their livelihoods and meet their aspirations for work-life balance. This requires bigger-picture thinking matched by long-term investment. The direction of these investments needs to anticipate evolving social needs and demographic shifts, and to avoid generating intergenerational inequalities. It will involve investment in new forms of enterprise, new ways of working, and lifelong reskilling.

> Governments have the opportunity, and to a certain extent the responsibility, to build the foundations of a new era of sustained, inclusive, and sustainable growth.

An Aging Workforce

Another challenge is aging. As the OECD has been insisting, the aging of our workforce is one of the most powerful and sometimes underestimated economic trends we face. If we look at history, we find that an aging population almost always coincides with slower economic growth.

It is therefore crucial that investment policies create the right incentives for companies to invest in sectors and projects that encourage greater labor-market participation among older workers. Our investment policies should support companies in implementing age-sensitive workplace design and age-sensitive management concepts and promote lifelong learning for aging workers. Aging will be one of our countries' main economic challenges in the next 50 to 100 years, and already it provides interesting business cases for new markets and investments. Promoting evidence that proves the value of investing in an older workforce and identifying key areas for successful investment could encourage enterprises to take action. This is something that we are pursuing at the OECD.

Climate Change and Renewable Energies

Climate change is one of the most pressing global challenges. The latest Intergovernmental Panel on Climate Change report states that global warming is unequivocal and that since the 1950s, many of the observed changes are unprecedented. The increasing dependence of the global energy system on fossil fuels illustrates the challenge of shifting investment into emissions reduction or climate-mitigation strategies. Reducing emissions really does matter. The momentum of climate change is increasing, and the impact from that is inevitable. In this respect, green investment as a driver of growth has become an absolute necessity.

Creating a global low-carbon energy sector will require an additional cumulative investment of $36 trillion by 2050, including $7.35 trillion in the power sector.[4] To enable this green-energy transition, annual energy investment alone will need to rise steadily toward $2 trillion, while annual spending on energy efficiency must increase to $550 billion.[5] Crucially, strong signals must be sent to counter the rising price of emissions and to reach the desired zero-emissions trajectory. Reforming environmentally harmful subsidies is a priority. Greater transparency is needed to provide a complete picture of who receives and benefits from fossil-fuel subsidies.

Upgrading Infrastructure

Upgrading the infrastructure of our countries is another long-term challenge that can benefit from patient capital for long-term projects. Governments and private developers planning major urban-infrastructure investments need to consider the effects of climate change, and not just mitigation costs. To support a global population of more than nine billion people by 2050, investment in cleaner, modern energy systems and smarter, more sanitary cities is paramount and needs to start now. The OECD estimates that global infrastructure investment (transport, water, telecommunications, electricity generation, transmission, and distribution) by 2030 will require around $71 trillion, which amounts to 3.5 percent of global GDP over the same period.[6] The perception that the impact of climate change is too distant and uncertain to warrant investment of that magnitude is misguided given the inertia of complex technological systems, such as energy and transport systems. New policy frameworks are therefore needed to incentivize and reward climate-responsible investing with a fair and certain return.

These are just a few examples of structural challenges that can and must be addressed through long-term investment. But how do we do this? How do we build the necessary framework and the right incentives to encourage private investors to pursue these types of investments with a responsible, long-term vision that can match short-term, business-oriented objectives? Here are some ideas.

POLICY PRIORITIES FOR LONG-TERM INVESTMENT

1. Promoting Consistent Policies and Framework Conditions

Beyond immediate uncertainties, investment is in part held back in structural terms by a lack of investment incentives as well as factors that actually reduce the returns to investors. These include restrictive product-market regulations that reduce the ability of firms to undertake new activities or enter new markets, especially across borders.

The regulation of capital-intensive network industries and ownership restrictions can hold back productive investments. The regulatory environment also needs to be predictable and stable. Regarding infrastructure investment, specific problems related to planning and a limited capacity to prepare and execute projects successfully may also be a factor in discouraging investment.

Governments and competent authorities, such as regulators and supervisors of institutional investors, need to play a greater role in offsetting such impediments through consistent policies and framework conditions.

2. Facilitating the Participation of Institutional Investors

The challenge of long-term investment cannot be resolved without attracting more diverse and private sources of finance. Traditionally, banks have been a leading source of long-term capital to finance private-sector investment. The banking model, however, has evolved, becoming increasingly dominated by wholesale markets, derivatives in particular, to the detriment of the more traditional deposit-taking and lending activities. Disintermediation and the growth of capital markets has led to a shift in the structure of the financial sector, with institutional investors such as pension funds, insurance companies, mutual funds, and, most recently, sovereign-wealth funds also becoming important providers of long-term capital.

Institutional investors in OECD countries alone in 2012 held over $80 trillion in assets, with pension funds collecting about $1 trillion in new contributions over the course of the year.[7] They have been looking for new sources of long-term, inflation-protected returns and could play an important role in bringing about significant and diversified long-term financing across all sectors of the economy, including infrastructure, education and skills training, R&D, and new technology.

Asset-allocation trends observed over the last year show a gradual globalization of portfolios, while the interest in emerging markets and diversification into new asset classes became more pronounced and more widespread. Investment in infrastructure is growing rapidly but remains limited, representing about 1 percent of total assets on average across the OECD.[8] Clearly major barriers still exist.

The role of institutional investors in long-term financing is constrained by the short-termism increasingly pervasive in capital markets, as well as structural and policy barriers such as regulatory disincentives, lack of appropriate financing vehicles, limited investment and risk-management expertise, lack of transparency and a dearth of appropriate data and investment benchmarks for illiquid assets. These issues are reflected in the G-20/OECD High Level Principles for Long-Term Investment.[9]

Tools for governments to offset these impediments and to leverage institutional investment include public–private partnerships to develop clear and transparent project pipelines for major green infrastructure projects, green banks, which provide low-cost financing for clean-energy projects, and green bonds, which raise investment funds for projects aimed at mitigating climate change. It is also important to develop new risk-mitigation and credit-enhancements tools (the Europe 2020 Project Bond Initiative is one interesting example) to ensure that institutional investors gain access to financial vehicles with the appropriate risk-return profile.

In addition, there is scope to redirect bank business models through more efficient growth-oriented financial regulation that does not unduly hamper financing for investment, including lending to the small- and midsize-enterprise sector.

High youth unemployment has led to protests, like this one in Seville, Spain, in 2011.

3. Using Regulation to Foster Long-Term Investment

The removal of regulatory constraints to investment in areas like infrastructure is also necessary. Unduly burdensome regulation may take the form of bans on unlisted or direct investments. While investment restrictions are important to protect pension-fund members, particularly in developing economies, an unintended consequence may be barriers to investment in infrastructure. In addition, international accounting and funding rules may be inadvertently discouraging institutional investors from investing in longer-term, illiquid assets.

Major financial agreements such as Solvency II, Basel III, or the European banking reform need to look closely at the issue of incentives.

4. Strengthening of Public-Equity Markets

Sustainable businesses create jobs and serve shifting social needs. Channeling savings to corporations that need capital for innovation and sustainable job creation is therefore critical.

Stock markets have traditionally been central in channeling capital. Corporate-governance rules and regulations establish the framework for financing corporate investment through capital markets and for establishing shareholder participation in the decision-making process of corporations. The effective functioning of capital markets is key to the quality of corporate governance, and vice versa.

Embedded short-termism is a systemic challenge that is already recognized by many stakeholders, within and beyond the financial system.

Today, however, the quality of corporate-governance frameworks worldwide is challenged by fundamental developments in financial markets, including the increased role of nonbank financial intermediation, the greater complexity of the investment chain, the dominance of passive and short-term investment strategies, and the extensive holding of idle, uninvested cash by the corporate sector.

Stock markets were designed in a way that improves the conditions for effective financing of corporate investments by providing economic incentives for individual and institutional investors. Regulatory uncertainty regarding the roles and responsibilities of the various intermediaries in the investment chain should be reduced, and unnecessary intermediation costs should be eliminated, to increase the efficiency of capital allocation and corporate access to capital. These regulatory arrangements are of fundamental importance for aligning the incentives of intermediaries and the households that are the ultimate beneficiaries of these investments.

5. Building Long-Term Synergies

The shift in wealth from West to East presents opportunities for new global synergies. Trillions of dollars of savings, particularly in OECD economies, are trapped in suboptimal investments earning poor returns. Meanwhile, many developing countries face a serious shortage of capital, even for investments that can generate high financial and economic return. The world's financial system is not adapted to shifting the balance of the two extremes. The flow of new investment will require emerging economies to institute structural reforms within their banking sectors and to improve the productivity of their national economies.

In this respect, the OECD has an important role to play within the context of the G-20 in promoting common principles. This work covers, notably, the international-investment dimension of competitive neutrality, removing restrictions on foreign direct investment, and promoting horizontal and vertical policy coordination.

The public sector has long financed the lion's share of innovation leading to fundamental economic transformations, such as railroads, healthcare, and the Internet economy. The state's entrepreneurial role needs to be recognized and acknowledged to enable a fairer share of return on investment, but also, crucially, to secure public-sector buy-in for reinvestment in the next wave of technological developments. Long-term investment systems will need to better recognize the role of the state and other new sources of financing for innovation in the public interest, rather than catering to the desires of an elite.

The lack of investment in the productive assets of the "real" economy, that is, a skilled workforce, new businesses, and modern infrastructure, must be urgently addressed through a mix of policy measures that attract new investors to infrastructure, strengthen corporate governance, and align behaviors around long-term metrics.

Embedded short-termism is a systemic challenge that is already recognized by many stakeholders, within and beyond the financial system. The challenge now is to pave the way forward by creating incentives for better investment on a whole-of-system basis. It is not enough to simply increase investment if the outcome is to replicate the socially and environmentally damaging aspects of yesterday's economies.

In a globally interdependent world, a better financial and investment system cannot be achieved on a country-by-country basis. While there is no one-size-fits-all model for economic development, without global standards and complementary regulations there will be no global future.

The OECD is focused on supporting its member states, the G-20, and its partners to step up and lead by example. We are uniquely positioned to recognize the complex linkages among the financial world; the real economy of goods, services, and innovation; and societal well-being. Only by enabling systems that make long-term investments in a sustainable global future can all of humanity hope to flourish. ■

The lack of investment in the productive assets of the "real" economy, that is, a skilled workforce, new businesses, and modern infrastructure, must be urgently addressed.

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[9] The OECD has developed an important project on long-term investment—the "Institutional investors and long-term investment" project. Drawing from international experience, the project aims to facilitate long-term investment by institutional investors such as pension funds, insurance companies, and sovereign-wealth funds, addressing both potential regulatory obstacles and market failures. For more, see oecd.org.

Long-Termism Begins with The Board

Ensuring commitment to a long-term mind-set requires a fundamental reconstitution of boards.

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It's not hard to tick off the steps necessary to instill long-term thinking in an organization. We all know what is required: an ambitious corporate vision supported by a long-term strategy that is informed by the needs of stakeholders, present and future; incentives based on long-term performance, with well-thought-out metrics and benchmarks; rigorous and balanced capital management; and meaningful, ongoing dialogue with all constituents, including investors, to name just a few items on the reform agenda.

Although the elements are clear, creating and sustaining a culture of long-termism has proved difficult. I believe the solution to this paradox lies with the board. None of the required steps can be effectively implemented without a strong, engaged board whose members are deeply immersed in the organization's strategy. Attaining that level of engagement will require directors to become more deeply involved with a variety of issues, from market forces and investor relations to talent development and compensation. Most of all, it will require a repositioning of strategy on the board agenda from "nice to have, if there's time" to "absolutely critical, even if we have to drop something else."

The requisite mind-set of this newly reconstituted board is clear. Just as we are asking management, investors, and other stakeholders to take a longer-term view, directors too must look beyond the traditional measures of corporate success such as the quarterly earnings report and accomplishments since the last board meeting. Short-term performance matters, but it should be assessed in the context of long-term goals: given the stated objectives for the next 5 or 10 or 20 years, did management execute as well as possible? Did the company meet its milestones and benchmarks? This is an entirely different evaluation from asking whether the company met the consensus-earnings forecast. Often, short-term performance can be driven by market fluctuations beyond the control of management. What management can control is the development and execution of an intelligent long-term plan that will create sustainable value for stakeholders.

THE URGENT VERSUS THE IMPORTANT

Widespread agreement exists that boards should focus more directly on strategy. Indeed, board members are often recruited specifically because of the unique contributions they are expected to make to the company's strategic plan. Despite this, strategy remains the stepchild, often garnering only the most cursory review by the board. There are many reasons for this, but at heart, it's because too often the urgent triumphs over the important. Who has not experienced a board meeting that runs over schedule, with the strategy discussion being the first thing that gets sacrificed—not the last thing, the *first*. With all of the other demands on the board, strategy becomes a box to check: a task to be engaged with and accomplished at the annual board off-site, not to be thought of again until it is time to dust off the plan for the following year's retreat. Unless we can make long-term thinking the driving force behind boards' mission and governance activities, no amount of change to management incentives, investor behavior, or the like will be sufficient to ensure a focus on the long term.

I am fully aware that this call to action comes just as postcrisis regulatory burdens are squeezing boards like never before. It's not as though boards took a vote and decided to ignore the long term. We need to recognize that the role of the board and the job of director are more complex and demanding than ever. Moreover, some of those demands are in direct conflict. On the one hand, intense pressure exists to ensure attractive results every quarter. Yet stable, sustainable economic growth over the long term often requires companies to put long-term goals ahead of short-term gains.

Making that trade-off effectively and accommodating other growing demands requires greater expertise and a substantially larger time commitment than is typical of many boards today. The executive-board relationship and, to some extent, the basic management-board governance model must evolve. The job of filling board seats becomes even more critical, requiring a well-thought-out strategy to assemble the needed talent

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and expertise. Companies and their stakeholders must be prepared to increase director compensation and support the board in a variety of other ways.

So why, exactly, does long-term strategy and focus always seem to fall to the bottom of the corporate-board agenda? The answer is simple arithmetic. In the wake of the global financial crisis and the corporate-accounting scandals of the early 2000s, the increased regulatory burden and heightened perception of risk has forced boards to spend more time focused either on the present or the immediate past. Examples are numerous. Sarbanes–Oxley imposed enormous additional responsibilities on US boards for compliance. Regulatory requirements in virtually all industries have increased, with new obligations and accompanying penalties. Moreover, many of the traditional board duties, such as CEO succession, talent development, and executive compensation, while critical, also encourage a focus on immediate needs rather than long-

The Sarbanes–Oxley Act and other regulations enacted since 2000 have added to an already crowded board agenda.

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term strategy and goals. The result: less focus on the long-term mission than ever before. As the job of director has become more complex, surveys show that directors have responded by devoting more time to their roles. However, the extra hours have not been enough to offset the array of new demands. If the additional time required has gone up by x, the additional time spent has gone up by something substantially less than x.

FROM MONOLOGUE TO DIALOGUE

Time constraints are not the only impediment. Many boards simply lack the expertise to lead and govern management on the company's long-term needs. This is not to say that directors are unqualified or ineffective. In many ways, I think boards have never been stronger. However, many lack the experience and expertise to engage effectively and critically with management in regard to their particular company's long-term planning. As a result, the strategy debrief becomes just that, a presentation from management to a board that sits back and becomes an audience rather than an engaged thought partner.

That audience-presenter paradigm, which is more prevalent than most would like to admit, is an outgrowth of yet another serious issue: many boards remain mired in an outdated model of the governance relationship. I am not advocating that boards become involved in any way in the day-to-day running of the organization. That is, and must remain, the purview of the CEO and the executive team. However, I believe that too many boards define their prerogatives too narrowly. Board engagement too often is one of monologue rather than dialogue, with the speaking roles limited to management. Many areas exist—long-termism being one of the most important—where directors should have not just ample scope but also an affirmative duty to probe deeply. That is not possible if the board's understanding of the issues is limited to the information presented by management. The board collectively needs to bring a comprehensive set of competencies and experience to advance and add value to the discussion while also enabling the vigorous pursuit of legitimate concerns. In addition, by allowing their roles to be defined narrowly, directors risk cutting themselves off from important additional avenues of information. I would include here rising talent within the organization, outside experts, and, perhaps most important, the investor community.

These issues of time commitment, expertise, and role are structural in nature. Addressing and resolving them will require significantly rethinking the way boards function. Taking on these expanded responsibilities will require new ways of managing and supporting the board to allow it to function more effectively. Most of all, change will require a diverse group of talented, driven, determined individuals, each of whom brings particular expertise to bear.

A primary lever is board recruitment, which becomes an even more critical function when viewed through the lens of long-term focus. Most boards have appropriately focused on broadening diversity on the board. Diversity of thought is at least as important as other forms of diversity. Each vacancy should be considered an opportunity to add additional expertise and perspective to the board. That diversity can be deep experience within the industry, firsthand experience with a particular challenge the company faces, or even a deep understanding of a particular stakeholder group, such as a customer segment, supplier group, or particular geography. Collectively, the directors should bring the experience, expertise, diversity of perspectives, and wisdom to test strategy and become true partners to the CEO.

Given the time constraints on boards, the need for well-functioning board committees escalates. Just as we expect companies to effectively organize their work and their functions, we need the same from boards. Skilled board committees, appropriately supported with staff and administrative help, can address the burgeoning workload of boards while also freeing up time for the board overall to focus on the long term.

Increased use of outside professionals can also help boards effectively govern a long-term-focused company. Just as boards now engage compensation experts, they should also consider other kinds of experts to bring them up to speed on specific areas when need arises. The outside adviser is especially important when management is proposing a strategic direction that requires specialized knowledge to evaluate it thoroughly and that expertise is not present among current directors. The adviser may or may not be the same person or firm advising management. The idea is to make sure that the board gets the background it needs as quickly as possible and is equipped to ask all the necessary questions and engage effectively in the consideration and evaluation of strategy.

The overall goal is to reprioritize the board agenda, to create a mind-set that says, "Long-term strategy is the most important thing we do." To make the strategy discussion a true discussion rather than a presentation requires the board to be deeply immersed in all elements. That is why a significant number of directors—two to three—must have deep expertise in the company and the sector. I realize this can be difficult. Bringing in a veteran of a close competitor potentially raises conflict issues. Nonetheless, without that deep background, a true dialogue between management and the board may be difficult to achieve.

LEARNING THE ORGANIZATION

Even members without that immediate experience can expand their understanding of the organization by engaging more deeply with it. The board talent-management process can facilitate this understanding. Engaging with high-potential individuals beyond the CEO's direct reports is a useful means both to deepen the board's strategic understanding and to fully grasp the company's talent position. One CEO I know asks each director on her board to mentor two or three high-potential managers a level or two below the CEO's direct reports. While this undoubtedly provides support and guidance to the young executives involved, it also gives directors valuable new perspectives on the organization. And, of course, building confidence in the next generation of leaders is itself critical to the long-term performance of the company.

> Many boards lack the experience and expertise to engage effectively and critically with management in regard to their particular company's long-term planning.

Board engagement with investors is particularly important to sustaining the commitment to the long term. Yet, the typical board does not engage meaningfully with investors, the very group that elected them and whom they purportedly represent. To ensure consistency of message, boards should consider appointing a group of directors (including the chairman) to develop deep relationships within the investor community. These directors can meet periodically with current and potential investors, both with and without management. Perhaps the company invites investors in for a series of conversations, first with management and then with a selected director or directors. A knowledgeable and engaged board whose members articulate the same goals with the same language as management signals to investors that the strategy has been carefully developed and stress tested within the organization and that the organization is prepared to stay the course. The more companies are able to develop a base of long-term investors who understand and support the long-term mission, the more latitude management will have in working toward those goals.

The more companies are able to develop a base of long-term investors who understand the long-term mission, the more latitude management will have in working toward those goals.

Deep engagement with investors will bring other benefits as well. By understanding how investors perceive the company, its management, and company strategy, boards can gain invaluable insights that should help to sharpen thinking and communications. Directors who engage deeply with investors may discover serious misalignments between management's perception of the organization's value within a portfolio and investors' perspectives. Bringing those two views into sync can only strengthen the company.

There is no room on this new, long-term-focused board for passive members who simply show up to meetings. As noted earlier, the board will require a more significant time commitment. For this reason, directors who are sitting executives should be limited to just one outside board. Retired executives should be limited to no more than three to four board memberships, including nonprofit boards. The chairman, whose commitment will approach full time, should be limited to no more than one other board position, and that should not be a lead position. Compensation obviously needs to reflect this expanded role and the limitations on other board activities. Since the goal is a more long-term mind-set, compensation should reflect long-term performance. Thus, pay should be wholly or mostly in the form of equity, to be paid out over a long period.

Both leading a board through this type of reconstitution and maintaining focus on the long term will require even more from the chairman. Although controversial to some, I believe this heightened leadership requires a separation of the roles of chairman and CEO. The need to maintain a sustained focus on the long term, while also providing day-to-day thought partnership and driving improved board functionality, suggests that the chairman role is distinct and requires its own focus. Moreover, given the continuing decline in CEO tenures, the chairman role can be a vital sustainer of the long-term focus.

Virtually all express support for a long-term approach to strategy, investment, and company performance. Many levers, such as strategy development, measurement, talent development, and incentives, must be pulled to secure a long-term focus. Yet each of these levers—and alignment across these actions—requires thoughtful board action. Making this transition will require skill, cooperation, and patience from all. The place to start is with the board. ■

Donald Kaberuka

Taking the Long View on Africa

Short-term thinking blinds much of the world to the region's potential.

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The world's perception of Africa seems to be driven by a fixation on the region's immediate challenges. As a result, long-term trends of huge significance are underestimated. The continent's demographic advantage of a young and growing population, its rapid urbanization and growing middle class, the spread of information and communication technology in the region, and large natural-resource discoveries all seem to be discounted.

There is little doubt that Africa's political and economic prospects have improved dramatically in the past two decades. Despite the outbreak of Ebola in some countries, Africa is no longer the crisis-prone, debt-ridden, aid-dependent entity that it was held out to be for much of the past half century. Examples of this recent progress abound. Following a decade of rapid growth, Africa is now the second-fastest-growing continent after Asia. It has also shown a marked economic resilience, particularly during the global financial crisis, when Africa resumed growing apace after just a short downturn.

Social-development indicators have improved as well. For example, child-mortality rates have declined sharply during the past decade. HIV infection rates decreased by 74 percent, while malaria deaths have dropped by 30 percent. These outcomes have had a positive impact on average life expectancy, which increased to 55 years—an increase of seven years compared with the early 2000s. Another promising indicator is that poverty has decreased, although inequality has increased.

This impressive turn of fortune is explained primarily by four factors. First, there has been a great improvement in economic management, which has contributed to macroeconomic stability, stimulated foreign-direct-investment flows, opened up the continent to international trade, and boosted private-sector activity. Between 2001 and 2012, the investment-to-GDP ratio stood at 23 percent, surpassed only by the developing Asian economies. Second, there has been a large and unprecedented demand for Africa's natural resources, including minerals and oil, from China and other emerging-market economies. Third, the continent boasts a sizable and growing middle class, which is driving private consumption—and demand for consumer goods. For some African countries, this is providing an impetus for industrialization. Fourth, increased financial flows, including portfolio investment and remittances, have spurred growth. Since 2000, external financial flows have increased fourfold and are expected to exceed $200 billion in 2014.

Africa has a demographic dividend that derives from an increase in the working-age population and a decrease in the dependency ratio, and must make the most of it.

LOOKING AHEAD

Three questions will be important in determining Africa's future progress. Can it navigate the transition to a younger, larger population? Can it optimally deploy the natural-resource rents it brings in? And can it ensure that its economic growth is widespread and long lasting? Africa's population is projected to reach 2.3 billion people by 2050—double its current size. More than a quarter of that population will be between the ages of 15 and 24. This would give Africa the largest workforce in the world, even surpassing India and China. Africa has a unique opportunity to take advantage of a demographic dividend that derives from an increase in the working-age population and a decrease in the dependency ratio, and must make the most of it. The window of opportunity, however, is short. The youth bulge will end within the next decade or two. To reap the demographic dividend, Africa, especially sub-Saharan Africa, must do its part to support the opportunities that spring from this demographic shift—for example, by helping to control fertility rates. This can be achieved by keeping girls in school longer and by providing better social services, including family planning. These changes would make it possible for women to increase their labor-market participation and ensure better health outcomes for their offspring.

Capturing the demographic dividend will also require a much greater effort to create adequate employment opportunities. Other policy challenges include managing rapid urbanization, improving aggregate domestic savings, and attracting higher volumes of foreign direct investment. Equally important, countries need to take greater advantage of new technologies—which were not available to East Asia, for example, when that region started reaping its own demographic dividends three decades ago—to speed up the continent's transformation. But to have a lasting impact, new knowledge and technologies and higher growth rates must be complemented by strong and accountable institutions.

Along with its demographic advantages, Africa is endowed with abundant natural resources, including recent oil and gas discoveries, located in a range of countries. For some countries, such as Mozambique, the new finds are unprecedented. In 2012, four out of the five largest gas discoveries in the world were in Mozambique. The African Development Bank Group estimates that over the next 20 years, Africa's natural resources, especially from the extractive industries, could contribute over $30 billion annually to government revenues.

The hope is that natural-resource revenues will help countries establish robust and diversified economies. Unfortunately, this is not yet happening. Instead, resource-rich countries seem to be trapped in a vicious circle of primary-mineral exports, with little value added to the local economy. In the 20 years leading up to 2012, raw-material exports accounted for 76 percent of Africa's exports, while manufacturing accounted for only 20 percent. In many countries, the potential for agroprocessing is good, although progress in linking up to the regional and global value chains will depend on how quickly governments are able to upgrade infrastructure and further improve the regulatory and business environment.

Although economic growth has been impressive, Africa still exhibits higher levels of inequality than other regions of the world, with the exception of Latin America. In 2011, for instance, six of the world's ten most unequal countries were in Africa. While historical factors might explain this disparity in some regions, particularly in southern Africa, elsewhere it has been mainly the outcome of policies that have failed to put in place adequate measures to help those living in poverty. Addressing the growing inequality in Africa will require active social policies and innovative approaches to education and gender issues, as well as to small businesses.

Africa has a young and fast-growing population; by 2050, more than a quarter of its inhabitants will be between the ages of 15 and 24.

WHAT IT WILL TAKE FOR AFRICA TO SUCCEED

The dynamics of the global economy are shifting. In particular, the wage differential between Africa and other emerging markets is widening as countries such as China transition from being the low-cost "factory" of the world to being a producer of more technologically intensive goods and services. As this transition continues, manufacturing opportunities will open up for Africa. But this is only one part of the story. For Africa to attract investment, it is imperative that its governments take a strategic view of infrastructure and logistics. It will also require massive skills development, through targeted education to fill the skills gap. Above all, both government and industry will need to take a long-term perspective, forgoing short-term tactical profit maximization.

Success will also require a new relationship with foreign investors. There was a time when foreign investors, including multinationals, could undertake their activities with little or no attempt to reach out to local business partners. But the experience in many countries has demonstrated the importance of nurturing such partnerships. Local players, as one might expect, bring with them their own business networks as well as a deep knowledge of local conditions.

For foreign investors, maximizing these local labor and supply chains is not only sound business logic, it is also essential for sustainability. As indigenous workers gain a foothold in the production chain, more job opportunities will be created and partnerships will grow. Although a focus on foreign expertise and inputs might be expedient during the initial phases of the investment process, there must be a transition to local talent and resources if Africa is to reap the benefit of these activities and if they are to be long lasting.

> For foreign investors, maximizing local labor and supply chains is not only sound business logic, it is also essential for sustainability.

AFRICA'S INFRASTRUCTURE OPPORTUNITY

Infrastructure development also requires a long-term view. Along with improved logistical services, new roads, bridges, ports, and airports are critical for industrialization, competitiveness, and economic integration of African countries. The impressive growth rates witnessed over the past decade and rapid urbanization have led to a huge demand for both soft and hard infrastructure. Recent estimates show that the continent needs to invest around $93 billion annually to close the huge infrastructure deficit, with the financing gap estimated in the range of $50 billion to $100 billion annually. This presents both a challenge and an opportunity for business. In the 1990s, the deregulation in the telecommunications sector ushered in an explosion in IT-related infrastructure. We are beginning to see a similar phenomenon in the power sector.

Over the past decade, the African Development Bank Group channeled about 60 percent of its annual lending (close to $4 billion in 2013 alone) to infrastructure development on the continent—a substantial amount but still small in relation to Africa's needs. Our estimates are that for every dollar invested, an additional four were leveraged from private-sector investors. Forging viable partnerships with the private sector is therefore a major ingredient for accelerating development of Africa's infrastructure and enhancing its competitiveness.

Contrary to popular belief, much of the infrastructure development in Africa in recent years has been financed outside global aid programs, through domestic resources, asset-backed deals with China, international financial institutions, sovereign-bond issues, and other mechanisms. Looking ahead, the continent will have to compete with other developing regions for non-aid resources. There is a case for mobilizing additional domestic resources and capital, provided governments show the necessary political will by broadening their tax bases and strengthening tax administration.

Africa has crossed a threshold. Its young, vibrant population, thriving middle class, and bountiful natural resources represent a level of opportunity unsurpassed anywhere in the world.

Domestic tax sources, however, are not enough to generate the huge amounts required to meet Africa's infrastructure needs. Africa must find innovative new ways to finance critically needed infrastructure projects. Governments must find new ways to attract private capital for commercially viable and transformative projects. One step in this direction is a new program from the African Development Bank Group to target Africa's pool of savings from pension funds, sovereign-wealth funds, and insurance companies.

In the second decade of the 21st century, Africa has crossed a threshold. Its young, vibrant population, thriving middle class, and bountiful natural resources represent a level of opportunity unsurpassed anywhere in the world. Yet there are still lingering perceptions of the continent as a high-risk investment environment, perpetuating the tendency to see Africa, a vast and multifaceted continent, as a single country. That is why today the bulk of foreign investment in Africa is targeted at the extractive industries.

The world needs to take a fresh look. There are opportunities, for example, to serve the growing urban populations with their significant disposable incomes. There is enormous demand for financial services from the unbanked and underbanked. African-owned banks have already built up their capacity to take advantage of the opportunities that abound in the consumer retail sector and consumer services. The digital revolution has in many ways accelerated the process. Few people could have predicted the speed at which mobile telephony would accelerate the delivery of banking services, as well as education and health services.

While many African countries have accessed the international capital markets in recent years, indicating a diversification of their sources of financing, coupon yields are still relatively high—up to 8 percent in some cases—reflecting the perceived risks attached to lending to Africa. Measures must be taken to mitigate this risk but also to change misplaced perceptions.

We all need to take the long-term view. ■

Building A Board For the Long Term

Despite the more immediate concerns of investors, boards truly create value by looking further ahead.

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Short-term thinking increasingly dominates corporate decision making, particularly in the listed sector, where the pressure to meet quarterly earnings expectations has never been greater. Such is the pressure on CEOs and their management teams that all too often they are distracted from their true mission, which is to steer the business toward its strategic goals. While boards do have a duty to monitor performance against plans, they have an equally important role to play in keeping management focused on the long-term health of their companies. Boards need to become far bolder if they are to make an effective stand against the forces of short-termism, whether these come from inside or outside the organization.

Boards can choose to shake free from the straitjacket of quarterly capitalism, but doing so will require discipline and nerve, backed by a strong culture, shared values, and, most important, board leadership. Regardless of whether the chairman is independent or doubling as the CEO, he or she will need to take a strong lead, both philosophically and practically, in encouraging the board and management to look beyond short-term investor requirements to the needs of the wider community of stakeholders. The board should pay attention to short-term performance, naturally, but any pressure to change course or make decisions that merely satisfy short-term demands must be countered with a clear articulation of the company's long-term vision. The board's responsibility is ultimately to the long-term, sustainable health of the business.

Part of the board's ability to take a long-term view is informed by how it sees its responsibility to shareholders. The profile and expectations of investors have changed substantially over the past several decades, and all the evidence would suggest that in many markets long-term investors are a dying breed. Therefore, listed-company boards have to ask themselves whether their decisions should be driven mainly by a desire to satisfy shareholders impatient for short-term results or whether they should focus their efforts on working with management to develop a long-term vision for the business. This may arouse criticism and mistrust in some quarters, but it has the potential to create greater and more sustainable value in the long run.

LONG-TERM VISION AND STRATEGY

Definitions of the "long term" vary. We subscribe to the view that short term means one year or less, medium term is one to five years, and long term is more than five years. On this basis, we believe it is safe to say that few boards (and even fewer management teams) spend any significant time developing a truly long-term vision for the business.

On the whole, independent directors are appointed to the board for their ability to provide insights into the strategy proposed by management, yet boards commonly complain that they spend too little time discussing it. The preoccupations inherent in quarterly capitalism are often an unwelcome distraction for both management and the board, whose energies are better directed toward the bigger picture. As one chairman put it, "You can spend all your time trying to prevent accidents, or you can remember that your job is to create value."

We would argue that the board's first priority is to establish a long-term vision for the business, working collaboratively with management, and that this is a necessary precursor to management's development of strategy. What is the distinction? While corporate strategy is critical and comes with a set of milestones and goals that enable the board to measure management's progress, it is rarely fixed over a long period, necessarily evolving in the face of changing circumstances. By contrast, an overarching long-term vision acts as the lodestar that can guide the board and management as they look beyond the five-year horizon.

Boards should display greater confidence in communicating their organization's vision to the market. There are recent examples of companies behaving one way for investors but keeping their longer-term thinking under wraps for fear of a negative reaction. Many boards are nervous about committing to the long term and reluctant to reveal their forward thinking by admitting to investments that may not guarantee a return, at least not in the near term.

Independent directors are appointed to the board for their ability to provide insights into the strategy proposed by management, yet boards commonly complain that they spend too little time discussing it.

An impending EU rule change designed to discourage short-term thinking in financial markets may give the boards of European-listed companies more confidence in committing to long-term investment plans: interim management statements will no longer be mandatory, leaving companies to decide on the timing and content of their communications to the market. Boards should take full advantage of this new flexibility by refocusing investors on the company's longer-term goals.

CEO ALIGNMENT

One of the board's main tasks is to minimize the principal-agency problem. Since the wrong incentives lead to the wrong behavior, boards have to gear a major portion of the CEO's and senior management's reward package toward an appropriate set of performance-based objectives that stretch over five years and are benchmarked against a relevant group of companies, thus creating alignment between management and shareholders. We recommend that some element of the package should be held back until two years after the CEO leaves the business.

CEOs who have to hold their shares beyond their retirement or departure date will, we think, be more concerned about their legacy and the performance of their successor, since some portion of their wealth will remain locked up in the business. A well-managed CEO-succession process is vital for creating stability and continuity in the organization and for reassuring investors. We believe the process should start early in a CEO's tenure, be run by a dedicated committee of the board, and allow enough time for internal candidates to gain the necessary exposure and experience to prepare them for the role.

Every new appointment to the board should be framed by the question, "Will this person uphold the long-term vision of value creation for the business?"

Hiring mistakes are costly and can easily derail a long-term strategic plan, which should not change just because a new CEO has been appointed. As the strategy takes shape and continues to evolve, the board must review whether the current CEO is the right person to lead the organization through the next phase, bearing in mind that the person who led the development of strategy may not always be the best person to execute it.

THE RIGHT BOARD

With today's emphasis on compliance, the governance pendulum may have swung too far in our view, requiring directors to be too distant from the business. Every board has to consider carefully the trade-off between independence and knowledge. There is a strong argument holding sway in private-capital environments that a board made up of insiders who have an intimate knowledge of the business and a strong personal commitment to its success is more likely to be effective than one that contains detached outsiders with no day-to-day involvement in the company and no deep understanding of the issues it faces.

The reality is that independent directors will always be the majority on the boards of listed companies. However, if they are going to think long term and contribute to strategy in a meaningful way, they need to have experience in a relevant industry, a sophisticated understanding of the business, to know where its source of value lies, and to dedicate enough time to make a difference. Therefore, the board needs to consider four critical issues.

First, only people capable of developing that kind of understanding should be considered as directors. Having the best possible talent around the boardroom table really matters, and each individual should bring a unique set of skills and experiences directly relevant to the company's strategy. This means a rigorous assessment of candidates' intrinsic qualities to ensure that they have the intellect, judgment, and personality to contribute in the right way. Every new appointment to the board should be framed by the question, "Will this person uphold the long-term vision of value creation for the business?"

Second, directors must spend more time in the role and have fewer commitments. It may be appropriate for a select group of independent directors (committee chairmen, for example) to deepen their involvement in the business on a more formal basis. If this means that boards have to impose tougher rules on the number of directorships an individual may hold, so be it.

Third, directors need to be rewarded at a level that reflects these expectations. To secure the necessary time commitment, director fees should reflect the need for a deeper level of engagement, compensating them for any limits on their portfolio. Rewards for the chairman should properly reflect the significant level of responsibility and time commitment that goes with the role.

Fourth, chairmen or board leaders wanting to change the orientation of a board can strengthen this way of thinking by importing director talent from industries that are by their nature oriented toward the long term. Listed boards could benefit from the experience of family-controlled businesses in the appointment of executive and independent board directors. Family-controlled companies tend to hire directors who share their belief in preserving the company for the next generation. Many of the directors of the largest and most successful family-controlled companies have either been executives of other family-controlled companies who share a conviction about the importance of the long term or they are owners of other businesses run in a similar way. This is particularly noticeable in Germany, an economy powered by family-run businesses thriving in capital-intensive industries with long innovation and product-development cycles, some of them lasting 20 years or more, as in the case of Merck's ongoing investment in research and development of liquid crystals, which has resulted in their strong position in this sector.

Boards need directors who will become closely identified with the long-term vision for the business and are prepared to place the big bets. Some directors are more concerned with avoiding problems (and protecting their reputations) than making critical decisions for the business that may take time to bear fruit. Excessive risk aversion is as dangerous for the business as reckless behavior is at the other end of the spectrum.

Such concerns are rarely found on the boards of private-equity-portfolio companies, where hierarchical relationships (which can cause risk aversion) are all but eliminated. Private-equity boards not only tend to be highly engaged and knowledgeable but are also smaller and more hands on, so every director's contribution counts. Operating under fewer regulatory constraints and away from the scrutiny of external shareholders, analysts, and the general public, they have more time to devote to value-adding activities. They also tend to be highly analytical, working closely with management in a way that streamlines decision making and creates a strong culture of accountability.

THE RIGHT BOARD LEADERSHIP

It is impossible to overstate the importance of board leadership. (We refer below to the role played by independent chairmen, but we recognize that effective board leadership can take different forms. For example, in some US companies, different aspects of board leadership may be divided successfully between the CEO or chairman and the lead director.) The chairman sets the tone and direction for the board and has to ensure not only that an appropriate long-term vision is in place but also that the business has the human, financial, and technological means to realize that vision. Without a chairman continually upholding the long-term view, the idea will never gain traction.

The chairman must have sufficient conviction, influence, and resilience to stand firm in the face of short-term pressures. He or she is ultimately responsible for assembling the most engaged and knowledgeable team of directors possible to assist in this goal, although it is extremely difficult for any new chairman inheriting a board to change the attitudes and composition of the board overnight; constructing the right board can itself be a long-term endeavor.

The chairman's skill in setting and managing the agenda is critical, ensuring that sufficient time is allocated to longer-term strategic considerations, which can easily be crowded out by process issues, governance requirements, and urgent matters of the day. A good chairman will always be looking for the most efficient way to deal with the formalities to free up time for more expansive debate.

The chairman's commitment to the long-term health of the company needs to permeate the board and filter through to the whole organization. The board has a responsibility to ensure that the CEO is aware of and actively managing culture and values, articulating the company's strategic vision in a simple, clear, and consistent way. That message needs to be reiterated constantly to audiences inside and outside the organization, in language that reinforces the importance of the long-term health of the business.

As leader of the board, the chairman has to have the ability to switch between standing back and acting as a guide for the CEO and stepping forward to intervene. The skills required to do this effectively are rare. It is of course a huge advantage for the chairman to have run something of scale, and even better to have been exposed to crisis, if not failure, since being able to help a less-experienced CEO to apply the lessons from such experiences is invaluable.

BOARD-EFFECTIVENESS REVIEW

The principle of long-term planning should apply as much to the board as it does to the business itself, hence the importance of a properly conducted board-effectiveness review. When directors approach it with a positive, open attitude and a shared desire to improve the board's dynamics and behaviors, the review can be a powerful tool, especially when the uncensored results are discussed openly by the full board.

There should be no stigma attached to changing the composition of the board if a rigorous evaluation of the collective skills and experience suggests that new directors are needed to help the company achieve its long-term vision. It is possible for boards to get stale and fall into the trap of "fighting the last war" rather than focusing on the needs of the company several years out.

The review should contain questions relevant to the long-term orientation of the business:

- **Does the board articulate** its role in supporting a long-term vision for the business effectively?
- **How often** is this vision discussed at board meetings?
- **Does it inform** decision making?
- **Is the board sufficiently** engaged with long-term opportunities and threats, such as digital transformation, sustainability and the environment, or global shifts in the balance of economic power?
- **What different skills** are needed on the board to deal with these issues?
- **How willing** are individual directors to make way for new directors when fresh skills and experiences more closely aligned to the strategic goals are called for?
- **Is there a role** for term limits?

If long-term considerations are going to prevail over short-term interests, then the board has to become bolder and more courageous in exercising its collective responsibility, setting the tone for the business to think about its mission in a different way. Directors need clarity about whose interests they are representing, what the trade-offs are, and how best to address conflicting needs. They do not have to accept that their hands are tied, that they are simply there to do the bidding of shareholders who may be involved with the company but fleetingly. They can make a difference in a number of ways by committing themselves more deeply and exclusively to the business and by ensuring that all board activities and interactions with management and investors are underpinned by a clear understanding and articulation of the organization's long-term vision and values. By looking after the long-term interests of the company as a whole, directors can foster an environment that creates sustainable value for all stakeholders. ■

Angelien Kemna

The Impact Of Regulation

Pension funds and regulators must work together to foster opportunities for long-term investment while ensuring stable, sound, and safe financial markets

Angelien Kemna is a board member and chief financial and risk officer of Netherlands-based APG. APG manages the pension assets of nearly 4.5 million Dutch citizens for its clients, all Dutch pension funds. Previously, Kemna was chief executive of ING Investment Management Europe. She is a member of the board of governors of Leiden University and chairman of the supervisory board of Yellow & Blue Investment Management, a Dutch venture-capital firm that specializes in renewable energy.

Pension funds can play an important role in fostering long-term investment and economic growth. While banks continue to withdraw liquidity from the capital markets by making fewer loans, pension funds and their asset managers are well suited to fill that funding gap. Because our mandate is to fund the retirements of workers who may not be leaving the workforce for decades, we are able and willing to make very long-term investments. A long time horizon fits both the large scale and global nature of our operations and our fiduciary responsibility. More important, maintaining a long-term perspective benefits our pensioners, in whose interest we act. For these reasons, we strongly support the current global efforts to stimulate long-term investment.

It is, however, not only a matter of ability and willingness. We need to create the right incentives and at the same time remove barriers that constrain long-term investment. Unfortunately, regulation often forms one of those barriers. Obviously, regulation is vitally important: it serves as a traffic officer in the crowded streets of the financial markets. When drafted and applied correctly, it can be an effective tool for creating financial stability and restoring and maintaining confidence in

With the right regulation in place, green bonds could help finance environmentally beneficial projects like these wind turbines in the Netherlands.

the financial markets. When it functions to enable long-term investment, it can pave the way for citizens to meet their future financial needs.

But when regulations have the unintended effect of discouraging or even prohibiting long-term investment, they need to be identified and eliminated. Over the past few years, an enormous number of new rules have been created in reaction to the global financial crisis. In many cases, these rules have been too wide ranging. Failure to appropriately tailor regulations can close off opportunities to make long-term investments that could be widely beneficial. For example, new margin requirements for derivatives are meant to reduce systemic risk. Pension funds are highly creditworthy institutions that pose little or no such systemic risk to the financial markets. Forcing them to set aside assets for collateral purposes in the same manner as a bank or hedge fund does not make sense, and it results in a direct loss of long-term-investment opportunity.

CATEGORIZING THE IMPACT OF REGULATION ON LONG-TERM INVESTMENT

The impact of regulation on long-term investment is a complex matter. This is not only due to the fact that such investments involve a variety of products, market players, and jurisdictions. It is also because the inhibiting effect of regulation is often difficult to see and to quantify. To address this issue, we tend to distinguish different categories of regulatory impact on long-term investment in our discussions with regulators and supervisors.

The rules that encourage long-term investing (positive impact) are to be separated from those that discourage it (negative impact). Both forms of impact can either be direct or indirect. We classify rules that apply to actual long-term-investment products or strategies as having a direct impact. Rules that apply to other levels, such as investors, or to other products or parts of the market can also impact the ability or willingness to engage in long-term investment. We call this the indirect impact of regulation. That results in four categories of impact: direct and indirect positive impact and direct and indirect negative impact.

The problem is not only with the regulations that exist but also with the regulations that do not exist. In circumstances where regulation could have a positive impact on long-term investment but is lacking, it needs to be created. This goes for both the direct and indirect forms of positive impact. For example, standardization of regulations relating to covered and green bonds and cross-border investment through real-estate investment trusts would encourage more long-term investment. In a more indirect way, a general regulatory push for increased availability of long-term-investment projects and harmonizing of local insolvency regimes would also have a positive effect. We elaborate on these examples below. Failure to fill existing regulatory gaps will ultimately depress long-term investment.

Prominent examples of direct negative impact include proposed securitization regulations and rules on asset-based capital charges. These regulatory initiatives have the opposite effect of what we need: they hamper long-term investment. Indirect negative impact is more hidden in nature and thus less visible. Nonetheless, it can be just as important as direct negative impact. This is particularly true if the rules result in investors having fewer funds available for long-term investment. Margin requirements for derivatives transactions and the increase in banking costs that are passed on are crucial examples of indirect negative impact of regulation.

Negative indirect impact of regulation has taken a back seat in long-term-investment discussions. A report issued by the Financial Stability Board (FSB) in September 2014 on relevant regulatory long-term-investment factors[1] confirms this view. In its report, the FSB concludes that empirical evidence suggesting that regulatory reforms have had material adverse effects on the provision of long-term financing is lacking. In its continued search for data, the FSB then formulates a set of key indicators that could be taken into account. These indicators focus on existing capital flows and sources of funds. But this is only part of the picture. The funds *not* invested need to be mapped as well. If not, the indirect negative effects of regulation on long-term investment could become the assassin of long-term-investment growth.

FIRST STEPS FOR REGULATIONS THAT ENCOURAGE AND SUPPORT LONG-TERM INVESTMENT

Understanding the four kinds of impact can help bring about rules that safeguard markets while maximizing the opportunity for long-term investment. We offer specific examples for each category below. Although these examples are not exhaustive, we believe they offer good starting points for taking action toward regulatory improvement. In addition, they may help inform thinking in general on the different ways regulation can encourage or inhibit long-term investment.

1. Direct Positive Impact: Standardize Rules Across Jurisdictions

Standardizing the rules regarding covered and green bonds would be a straightforward way of creating direct positive impact. Currently, covered bonds, which are backed by a dedicated pool of assets, are subject to regional and even bank-specific rules. Regulators and investors should work together to create a global level playing field. In particular, standards should be formulated for overcollateralization, haircuts, valuation, the legal position of bondholders, and the treatment of residual debt. In addition, regulators and the industry should work to create common accounting standards for bondholders, as well as clear collateral requirements. Standards should include a requirement that covered bonds be rated by at least two rating agencies. Similarly, green bonds, which could be a powerful force for mobilizing capital for projects with environmental benefits, must be supported with effective regulation that mitigates the risk of greenwashing, or the unjustified appropriation of environmental virtue. Failure to formulate effective regulations will dampen the growth of this potentially beneficial market.

> When regulations have the unintended effect of discouraging or even prohibiting long-term investment, they need to be identified and eliminated.

Real estate, too, should be an important asset class for long-term investors. To that end, we would welcome the introduction of EU-based real-estate investment trusts, which could be used to facilitate cross-border real-estate investments, but again, they must be supported with effective and standardized rules.

2. Indirect Positive Impact: Tailor the Rules to the Investor

One barrier to long-term investment is a shortage of long-term-investment projects. Even taking market-generated and government projects together, there are simply not enough opportunities. There should be a broad assessment of how to stimulate the demand side of long-term investment through supporting regulation. Part of that assessment should take into account risk-return profiles and other relevant investment criteria for large institutional investors. The World Economic Forum's *Infrastructure Investment Policy Blueprint*[2] could provide pointers. As we have publicly stated,[3] to facilitate investing for pension funds and other large investors, governments must ensure clear and stable regulations. This should include eliminating fossil-fuel subsidies, higher prices for CO_2 emission rights, and increased support for research into cleaner energy, to make investments more attractive to pension funds and allow them to meet their sustainability goals.

One barrier to long-term investment is a shortage of investment projects. There should be a broad assessment of how to stimulate the demand side of long-term investment.

Discrepancies in local insolvency laws form a powerful indirect impediment to long-term, cross-border financing, especially within the European Union. These discrepancies create uncertainty and, therefore, risk in credit-financing transactions. They can also lead to excessive price fluctuation, especially in the case of default.

3. Direct Negative Impact: Distinguish Among Levels of Risk in Similar Investments and Investors

The (proposed) regulatory framework for securitization transactions has had a direct negative impact on investment behavior. Solvency II and Basel III proposals and resulting uncertainty about capital charges and liquidity treatment for securitizations have reduced investors' appetite to invest in this asset class. Securitized assets are an appropriate investment for pension plans, assuming they are properly structured and of good quality. They allow pension plans to contribute to the financing of real economy assets such as residential houses, consumer-loan leases, and loans to small and medium enterprises. There seems to be recognition today that the securitization markets need to be revived. In resetting the regulatory framework, however, special care must be taken to avoid unintended consequences. Rule makers must acknowledge that not all securitizations carry the same level of risk and make efforts to avoid unduly burdensome regulations.

Another area of direct negative impact concerns asset-based capital charges. Capital requirements for specific asset classes imposed by Solvency II will limit the amount of capital available for long-term investment. Here again, regulatory measures should take into account the varying risk profiles of different types of investors.

4. Indirect Negative Impact: Avoid Rules That Unintentionally Divert Cash From Long-Term Investment

There are numerous examples here. Current regulation of over-the-counter derivatives has, for instance, an indirect negative effect on the ability to contribute to long-term investment, as the rules reduce available funds. Measures like the European Market Infrastructure Regulation result in increased allocation to high-quality government bonds and cash for collateral purposes. Since returns on government bonds are and will continue to stay low, such measures force a deviation from an optimal investment mix. Derivative collateral requirements, whether imposed by regulation or by central clearing houses, can have a pro-cyclical effect in distressed markets by forcing fire sales of assets. Scarcity of eligible collateral will then have serious liquidity—and thus long-term-investment—consequences.

The increased banking costs that result from new regulatory measures are another source of indirect negative impact. Those costs are passed along to clients, including pension funds, once again reducing the amount available for long-term investment and forcing pension funds and other clients to pay the price for a crisis they did not cause. The net stable funding ratio, created by the Basel Committee on Banking Supervision, could prove to be yet another source of negative impact, since the rules would make it much more expensive to provide for certain equity products that are frequently used by pension funds.

Rules should be appropriately tailored for different market participants. Unnecessarily broad rules cause needless constraints and ultimately a loss of return for pensioners.

In the global debate on ways to enhance long-term investment, pension funds have correctly been identified as a potential source of nonbank funding. Executed correctly, regulation can stimulate our ability to engage in long-term investment. Done poorly, it can have the opposite effect. Care must be taken to avoid regulation that results in constraints on long-term investment in both direct and indirect ways. The serious problem of indirect negative impact, in particular, tends to be overlooked in this debate.

In general, the unintended consequences of regulation must be avoided at all times. The total impact on long-term investment of all individual pieces of regulation—plus how these pieces add up and affect one another—must be understood. In addition, rules should be appropriately tailored for different market participants. Unnecessarily broad rules cause needless constraints and ultimately a loss of return for pensioners.

For the long-term-investment debate to be effective, all forms of impact must be analyzed and carefully considered. This is not an easy job but one that must be undertaken to successfully encourage long-term investment. We are here for the long term, as are the global regulators and supervisors. It is our hope that with a joint effort, we can make sure that regulatory initiatives create stable and sound financial markets without diminishing the opportunities for meaningful long-term investment. ■

[1] *Update on financial regulatory factors affecting the supply of long-term finance: Report to G20 Finance Ministers and Central Bank Governors*, Financial Stability Board, September 16, 2014, financialstabilityboard.org.

[2] *Infrastructure Investment Policy Blueprint*, World Economic Forum, in collaboration with Oliver Wyman, February 2014, weforum.org. The blueprint contains a practical set of recommendations for governments on attracting private capital for infrastructure projects while creating clear social and economic value for their citizens.

[3] Angelien Kemna, speech at the United Nations Climate Summit, New York, September 23, 2014.

AUTHOR INDEX

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